

REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC) Lithuania

ACCOUNTING AND AUDITING

October 25, 2007

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Executive Summary

This report provides an assessment of accounting, financial reporting and auditing requirements and practices within the enterprise and financial sectors in Lithuania; it is an update and expansion of the World Bank's Accounting and Auditing ROSC (A&A ROSC) published in 2002. The report uses International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA) as benchmarks and draws on international experience and good practices in the field of accounting and audit regulation to assess the quality of financial information and make policy recommendations.

Accounting and Audit Reform in Lithuania

In the past few years, Lithuania has made significant achievements in updating the legal and statutory framework for corporate financial reporting. This has corresponded with Lithuania's accession to the European Union (EU) and the need to transpose EU requirements into Lithuanian law. These achievements have included modifications to the Law on Accounting, the Law on Financial Institutions, and most recently, further proposed modifications to the Audit Law. No instances of non-compliance with the *acquis communautaire* (the body of EU law) were noted. In addition, there have been institutional reforms in the areas of regulation of the securities, banking, and insurance sectors and of auditors. Many of these changes have met the recommendations made in the previous A&A ROSC report published in 2002. A summary of this commendable progress made against the main recommendations of the previous report is given following this executive summary.

However, further reform is needed in some important areas if the statutory framework for accounting, financial reporting and auditing is to conform to evolving EU requirements and international best practice, and to be comparable to similar frameworks across Europe. Some areas for consideration are set out below. Accordingly, this report recommends that the Ministry

of Finance of Lithuania takes the lead in working with the Parliament, key regulatory institutions and other stakeholders to continue to amend the Laws and regulations as necessary.

There has been little progress since 2002 in two of the key areas where recommendations were made in the previous report. These are (i) the enforcement of corporate financial reporting, and (ii) the training and education - and establishment of a profession - of accountants. The best statutory framework and laws are ineffective unless there is sufficient knowledge and capacity to comply with them and unless they are backed by appropriate enforcement measures. The high proportion of qualified audit opinions on Lithuanian financial statements and the low rate of compliance with the requirement to file financial statements with the State Enterprise Centre of Registers (SECR) are indicative of this low level of enforcement. To some degree, the lack of enforcement of high quality corporate financial reporting in compliance with the law exacerbates the capacity restraints as it restricts demand for financial reporting expertise, which gives little incentive for individuals or the private sector to invest in the training and improvements in education required to improve capacity. Another factor is the current low level of demand and usage of many companies' financial statements, partly due to many banks' lending decisions being made on the basis of collateral. However, some of this lack of demand and usage may be a result of the perceived poor quality of financial reporting.

The Lithuanian economy has grown rapidly despite the lack of enforcement of financial reporting and low accounting capacity; however, in order to maintain the country's high levels of GDP growth and further economic development, Lithuania needs to move toward further reforms in accounting and auditing to produce financial information of high quality. As more companies seek investment and growth capital, the need for high quality financial information will increase. Thus there is an immediate need to take measures to improve enforcement and to invest in capacity-building measures to both drive and meet this demand for better quality corporate financial reporting.

Recommendations to enable Lithuania to increase the effectiveness of its enforcement of the legal requirements for corporate financial reporting and to drive the increase in capacity of preparers of such financial information are outlined in detail in Section VI of this report, and are summarized below.

Ongoing Reform of the Statutory and Legal Framework

Key recommendations made by this report include that the statutory and legal framework be amended to:

- Implement the requirements of the amended EU Eighth Company Law Directive in a manner appropriate to the needs of the Lithuanian economy.
- Make financial reporting requirements for Small and Medium-sized Entities (SMEs) appropriate to the needs of the market and the SMEs own information needs.
- Consider increasing the approval and filing deadlines for non-listed companies

Improving the Enforcement Environment

Measures to improve the enforcement of legal requirements for corporate financial reporting include:

- Increase the levels of fines for late filing, lack of filing and inappropriate filing of financial information to enhance the enforcement environment of Lithuania.
- That the LSC, the State Enterprise Centre of Register (SECR) and the Accounting Institute of Lithuania (AIL) work to enforce the legal requirements for corporate financial reporting in a proportionate manner. Sharing experience with regional peers, such as Scandinavian countries and Poland, could be of key help in developing appropriate enforcement measures.

Institutional Capacity Building

All the regulators and institutions with responsibilities for aspects of the financial reporting process, face increasing challenges as the demand for high quality financial reporting grows and requirements for accounting and auditing become more sophisticated. In addition, Lithuania's lack of an established accounting profession and certified professional accountants increases these challenges. There is a consistent need for institutional and capacity building measures at each institution. In particular, the developing roles of the SECR and the AIL will necessitate extra resources if they are to be fulfilled effectively. Accordingly, this report recommends:

- That each institution should develop a long-term business plan, setting out the revenues and resources required to carry out its responsibilities and options for ways to fulfill these needs.
- That the Lithuanian Association of Accountants and Auditors continue its efforts to increase its membership in order to establish and represent an organized accountancy profession in Lithuania.

Section VI of this report outlines more detailed recommendations specific to each of the major regulators.

Reform and Further Development of Professional Education and Training

In parallel to improving the statutory framework and institutional capacity, there is a strong need to improve the capacity of the accounting and auditing professions. The genuine understanding and adoption of national and international accounting, financial reporting and auditing standards and requirements requires relevant education and training for financial statement preparers, auditors, and regulators. In this regard, it is essential to enhance the capacity of existing accountants as well as ensure the capacity of future accountants. Measures should include:

- A major program to re-train the trainers of accountants (professors of accounting and auditing at the university and college level). A program of re-tooling teachers of accounting and auditing in all three Baltic States and possibly other neighboring countries such as Poland may be useful.
- The Ministry of Education should consider reforms in tertiary level accounting and auditing education such as increasing experienced-based learning and involvement of employers and professional organizations.
- Actively supporting the Lithuanian Association of Educators and Researchers of Accounting in raising and standardizing the quality of accounting education nation-wide.
- Encouraging the development of an organized wide-scale accountancy profession by integrating professional and university and college education. Through the coordination of syllabi and subjects taught, professional associations should seek to offer exemptions from parts of their professional examinations, thus enhancing the attractiveness to graduates of joining the profession and the professional organization.

From ROSC to Reform

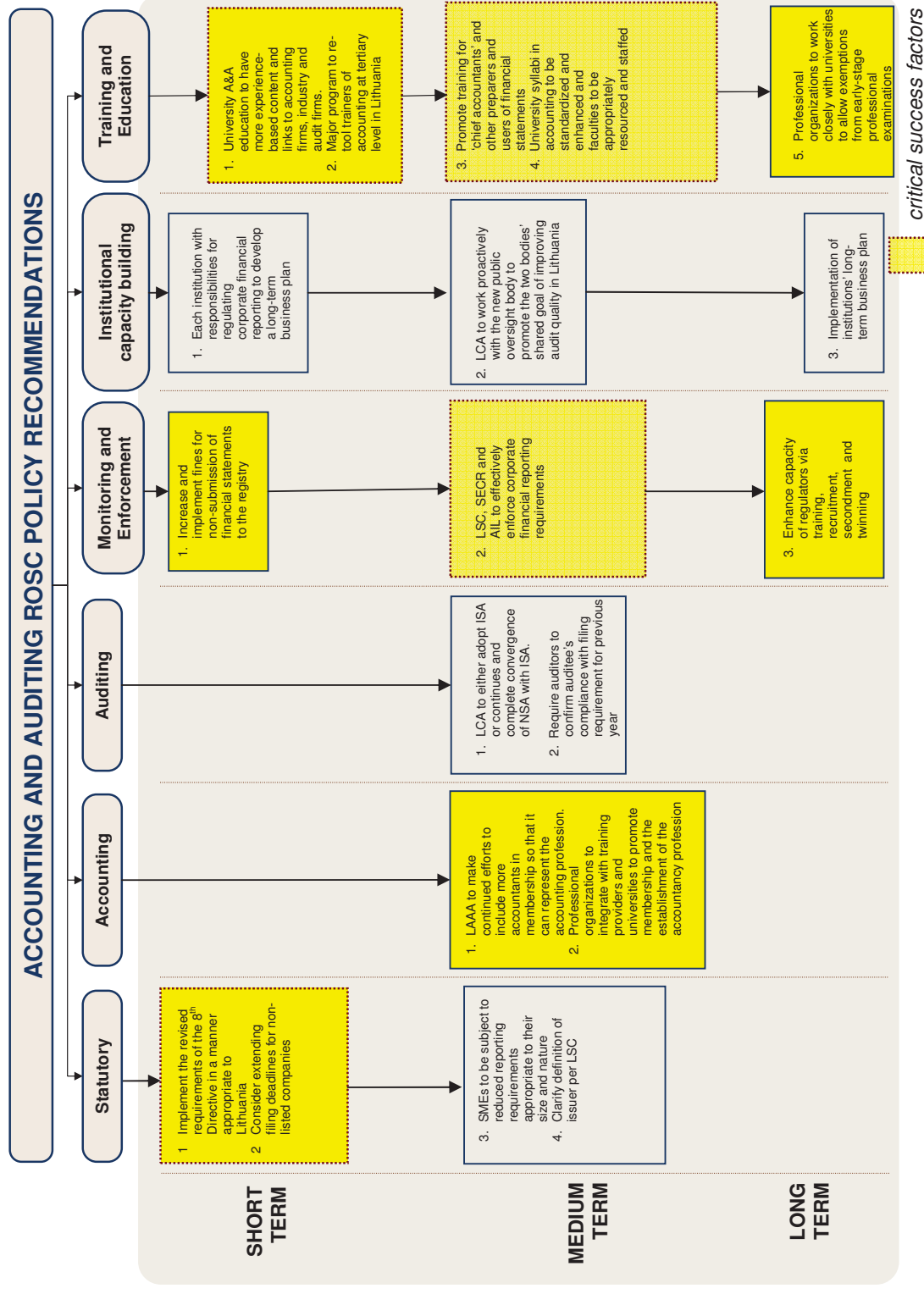
These recommendations require a holistic, multi-disciplinary approach and should be implemented as soon as possible following the publication of this report. Such implementation will require the cooperation of a wide range of stakeholder groups including the Government, regulators and the accountancy profession, and should be championed by a senior Government figure. In addition, input from peer countries may present Lithuania with unique insight into how similar policy situations have been dealt with in similar countries.

Lithuania should establish a multidisciplinary National Steering Committee (NSC) to coordinate the above accounting and auditing reforms. The NSC should advise policymakers and regulators regarding the implementation of the recommendations. Based on the successful experience of other countries, this report recommends that the NSC develop a Country Strategy and a detailed Country Action Plan which clearly sets out the key actions and allocates responsibilities for implementing the necessary reforms. The plan should include a itemized budget indicating the resources necessary for

successful implementation and the government, policymakers and development partners should work together to secure those resources so as to achieve the common goal of enhancing the quality and availability of financial information in Lithuania. The Lithuanian NSC should prioritize the actions of the government placing those actions which are of highest importance and/or which must be completed in a certain period of time in order to be compliant with EU legislation first and those with lesser importance and/or which maintain no time restrictions later.

Progress since 2002 on Key Recommendations of the Previous A&A ROSC

Recommendation from 2002 A&A ROSC	Achieved/ not achieved	Comments
1. Establishment of the Lithuanian Accounting Institute to set accounting standards in Lithuania, in particular standards suitable for SMEs	Achieved	This report recommends further consideration of the suitability of current BAS (based on IFRS) for the smallest of SMEs
2. Accounting Law to comply with EU 4 th and 7 th Company Law Directive	Achieved	
3. Audit Law to comply with EU 8 th Company Law Directive	Achieved	New draft Law in process to implement the 'new' 8 th Directive
4. Bank of Lithuania to properly distinguish between regulatory and general purpose financial reporting	Achieved	
5. Lithuanian Chamber of Auditors to conform audit standards to ISA and establish effective audit quality assurance with involvement of regulators	Mostly achieved	Lithuanian National Standards on Auditing largely conform with ISA. Audit quality assurance system established and nearing end of first complete cycle of inspections
6. Lithuanian Securities Commission to review compliance of regulated entities' financial statements with legal requirements	Not achieved	Lithuanian Securities Commission currently working to establish such review.
7. Accounting and auditing capacity to be increased through reforming university curricula and updating accountants in the enterprise sector	Not achieved	Similar recommendations in this report to improve and reform university accounting and auditing education and to target professional accountants in the enterprise sector



MAIN ABBREVIATIONS AND ACRONYMS

ACCA	Association of Chartered Certified Accountants
AIL	Accounting Institute of the Republic of Lithuania
AQCC	Audit Quality Control Committee, administered by the LCA
BAS	Business Accounting Standards (<i>Verslo Apskaitos Standartas</i>)
BCBS	Basel Committee on Banking Supervision
CPD	Continuing Professional Development
EU	European Union
GDI	Gross Domestic Income
IAASB	International Auditing and Assurance Standards Board
IAESB	International Accounting Education Standards Board
IAS	International Accounting Standards (included in IFRS)
IASB	International Accounting Standards Board
IES	International Education Standard
IESBA	International Ethics Standards Board for Accountants
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards (including IAS)
IMF	International Monetary Fund
ISA	International Standards on Auditing
ISQC	International Standards on Quality Control
ISC	Insurance Supervisory Commission of the Republic of Lithuania
JSC	Joint stock company
LCA	Lithuanian Chamber of Auditors
LAERA	Lithuanian Association of Educators and Researchers of Accounting
LLC	Limited liability company
LSC	Lithuanian Securities Commission
MoF	Ministry of Finance
BoL	Bank of Lithuania
NSA	National Standards on Auditing
NBFIs	Non-Banking Financial Institutions
NSPF	Non-State Pension Fund
PIE	Public Interest Entity
ROSC	Reports on the Observance and Standards of Codes
SECR	State Enterprise Centre of Registers
SME	Small and Medium-Sized Enterprises
SMO	Statement of Membership Obligations of IFAC
SOE	State Owned Enterprise
VSE	Vilnius Stock Exchange

I. INTRODUCTION

1. This assessment of accounting and auditing practices in Lithuania is part of a joint initiative of the World Bank and International Monetary Fund (IMF) to prepare Reports on the Observance of Standards and Codes (ROSC). The assessment focuses on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting in Lithuania and includes a review of both statutory requirements and actual practice. The report uses International Financial Reporting Standards (IFRS)¹ and International Standards on Auditing (ISA)² as benchmarks and draws on international experience and good practice in the field of accounting and auditing regulation.

2. Lithuania is a presidential, multi-party parliamentary democracy with GDP in 2006 of US\$30bn and a gross national income (GNI) per capita³ of US\$7,050. The country has an overall population of about 3.5 million people, with an estimated 553,000 people living in the capital and largest city of Vilnius.

3. Lithuania's economy is experiencing rapid growth and development. In 2000 the country's GDP growth (as an annual percentage) was at 4%; by 2003 it had increased to 7%. In 2003, GDP growth rose to 9% due to increased consumer demand and growth in private consumption. In 2004 and 2005, GDP growth returned to its 2002 level of 7% per year.

4. Lithuania's banking sector has developed greatly over the past 10 years. The Bank of Lithuania (the country's central bank) has been instrumental in overseeing the restructuring of troubled banking institutions and overseeing and strengthening the banking sector. The result of these efforts has been dramatic growth in the banking sector. In 2005, the domestic credit provided by the banking sector was 42% of GDP compared to just 15% only 5 years earlier. In addition, over the last five years, the percentage of bank loans that are rated 'non-performing' has been decreasing steadily. In the year 2000, this percentage was 11% of total loans; by 2005 it had decreased to 3%. Currently, the banking sector is dominated by several foreign-owned banks. There are 9 commercial banks and 4 foreign bank branches based in Lithuania. In addition, over a hundred banks of other EU member states (mostly from the UK, Germany, Austria and France) provide financial services in Lithuania without establishing a branch.

5. The Lithuanian insurance sector has developed significantly over the past few years. Legislative improvements and the country's increased competitiveness have attracted foreign insurers to invest in Lithuania. This can be seen by the spectacular growth of both the life assurance market (which grew by 22.8 % in 2005) and the non-life insurance market (which grew by 9.8 % in 2005). Although these increases are large, it is important to note that Lithuania's insurance market amounts to only about 1.5 % of GDP, which is still significantly lower than many other EU Member States. Non-life business insurance, in particular compulsory "Third-party Motor Insurance", has experienced significant competition in premiums written, which has resulted in increased claims ratios. Overall, Lithuania's insurance sector remains small with only 16 non-life insurers and 8 life insurers. However, in the next few years the insurance market in Lithuania is expected to grow strongly based on foreign investment in the market and increased activities of insurers based in other EU Member States.

6. The second pillar of the Lithuanian Pension systems allows allocating certain contributions to pension funds. In 2006, there were 30 second-pillar pension funds, 9 pension

¹ International Financial Reporting Standards are issued by the International Accounting Standards Board, an independent accounting standard-setter based in London, United Kingdom. In April 2001, the IASB announced that it would adopt all of the International Accounting Standards issued by the International Accounting Standards Committee. For simplicity's sake the term IFRS will mean both IFRS and IAS in this report.

² International Standards on Auditing are the standards issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants.

³ Per the Atlas Method as of 2005.

accumulation companies (6 of which were management companies). The share of pension funds managed by management companies under the supervision of LSC accounted for a majority of the pension fund market.

7. There are 46 companies currently listed on the Vilnius Stock Exchange (VSE). Of these 46 companies, 11 are on the main list, 31 are on a secondary list, the 'I list', which has less stringent requirements in relation to matters such as free float, and a further 4 have only debt securities listed. Due to the availability of cheap loan financing from Scandinavian banks, recent years have seen little demand from Lithuanian companies for access to the funds available from capital markets. To date, the banking sector has been prepared to finance the expansion of companies through collateral based lending; where necessary, contractual agreements ensure that banks have access to company's financial results. This has resulted in an overall lack of emphasis on the importance of generally available financial information and limited securities market activity. In the future, it is likely that companies will be unable to continue to mortgage assets to raise finance and instead will seek to raise loans based on future expected cash flows; at this time the availability of reliable, good quality financial information will become more important.

8. Lithuania has significant industrial capacity in machine building and metalworking, as well as the textile, leather industries, and agro-processing (including processed meat, dairy products, and fish). The country's diverse manufacturing base also includes an oil refinery, a nuclear power plant and high-tech computer production. Other industrial products include refrigerators and freezers, electric motors, television sets, metal-cutting machine tools, small ships, furniture, fertilizers, optical equipment, and electronic components.

9. Lithuania has privatized nearly all formerly state-owned enterprises; there remain 164 state enterprises in Lithuania. The Government of Lithuania completed banking sector privatization in 2001, with 85% of this sector now controlled by foreign (mainly Scandinavian) capital. The government has also completed privatization of the national gas and power companies. The foreign direct investment in the industrial sector accounted for close to LTL 13 billion (roughly US\$5.08bn) in 2006 and constituted 54% of the total annual foreign direct investments for that year. The industrial sector (defined as mining and quarrying, manufacturing, electricity, gas and water supply and construction) employed 28.2% of the workforce and accounted for about 31.5% of Lithuania's US\$30 billion GDP in 2006.

10. Even though Lithuania has made many improvements in their accounting and auditing environment to advance financial reporting, the perception that financial information is of low quality and the ability to use alternative methods when making business decisions (i.e. requiring collateral for lending and using personal business relationships/networking for supplier/customer relations) reduces the desire businesses and lending institutions have for the utilization and provision of high quality financial information. Although these alternative methods have been successful thus far and have functioned to make Lithuania one of the fastest growing economies in the region, in order to maintain these high levels of GDP growth and further economic development, the country needs to further reform accounting and auditing to produce financial information of high quality. Stable production of high quality financial information is needed to underlie the business activities (i.e. equity-based financing, greater freedom in contractual relations) that are found in longer-established flourishing market economies. For this reason, continuing the strengthening and development of financial reporting, accounting and auditing, and the regulatory framework that governs them, is necessary for the success of the Lithuania economy as it will increase the quality of financial information produced and will work to enhance private sector growth.

II. INSTITUTIONAL FRAMEWORK⁴

A. Statutory framework

11. **Business activities in Lithuania are regulated by the country's Civil Code (2000, No. VIII-1864) and the following laws: Law on Companies (2000, No. VIII-1835), Law on Partnerships (2003, No. IX-1804), Law on Individual Enterprises (2003, No. IX-1805), Law on Agricultural Companies (1991, No. I-1222), Law on Co-operative societies (co-operatives) (2002, No. IX-903).** Lithuanian civil law is influenced by the Roman-Dutch and German civil law models.

12. **Lithuania's Law on Companies regulates matters related to incorporation, management, activities, reorganizations, transformation, and liquidations of companies.** In addition, this law dictates the rights and obligations of shareholders and the establishment and cessation of activities of foreign company branches. Lithuanian legislation recognizes two main types of companies:

- Public limited liability company (Akcinė Bendrovė or AB): The shares of this form of company may be publicly traded, but are not necessarily traded. There are 679 public limited liability companies.
- Private limited liability company (Uždaroji Akcinė Bendrovė or UAB): The shares of this type of company are not publicly tradable. Companies of this type are 'closed' and their shares can be acquired only by designated shareholders. The private limited liability company can have no more than 250 shareholders; thereafter the law dictates that it should be transformed into a public limited liability company. Currently, there are 59,807 private limited liability companies.

13. **Other types and numbers of business entities include 164 State Enterprises, 1,733 Agriculture Companies, 530 Cooperative Societies, 628 Partnerships, 259 Limited Partnerships, 67,422 Individual Enterprises and 68 Credit Unions and other Credit Institutions.**

14. **The practice of having financial statements signed off by a chief accountant or firm providing accounting services has continued in some cases; however, according to current Lithuanian law, company chief accountants and firms providing accounting services are only responsible in law for the accuracy of bookkeeping entries.** In the case of regulated entities (banks, insurance companies, etc.) the signature of the chief accountant and chief actuary (in case of the insurance companies) is required by the market regulators. There are currently no legal requirements or restrictions on practicing accounting i.e. those offering their services to third parties. However, there is currently some debate on introducing such restrictions in Lithuania.

A.1. The Statutory Framework for Accounting and Financial Reporting

15. **Accounting and financial reporting requirements for enterprises in Lithuania are mainly regulated by four laws; the Law on Accounting, the Law on Financial Statements of Entities, the Law on Consolidated Accounts of Entities, and the Law on Audit.** The country's financial institutions (including banks, insurance companies and other financial institutions) apply provisions of the Law on Financial Institutions. Listed companies apply provisions of the Law on Securities and the Resolutions of the Securities Commission regarding additional requirements for disclosure.

⁴ This report outlines the legal principles applicable with regard to accounting, auditing and financial reporting and does not attempt to give anything more than an introduction to the issues. This report is not meant to be an exhaustive rendition of the law nor is it legal advice to those reading it.

16. **The Law on Financial Statements of Entities is applicable to all limited liability profit-seeking ‘legal persons’ and general partnerships and limited partnerships all participants whereof are public limited liability companies or private limited liability companies who are registered in the Republic of Lithuania.** In cases where entities which are not obliged to disclose financial statements choose to do so voluntarily, such financial statements must be drawn up in compliance with the requirements set by the Law.

17. **The Law on Financial Statements of Entities (2001, No. IX-575) sets out that annual financial statements shall present a true and fair view of an entity’s assets, equity, liabilities, income and expenditures.** Full financial statements shall consist of a balance sheet, a profit and loss account, a cash flow statement, a statement of changes in equity, and notes to the financial statements. Among other things, the Law includes:

- Ten ‘Generally Accepted Accounting Principles for the maintenance of accounting and the preparation of financial statements’.
- That entities whose securities are traded on regulated markets shall maintain and prepare financial statements in accordance with IFRS.
- That limited civil liability profit-seeking legal persons whose securities are not traded on regulated markets shall be allowed to perform accounting and draw up financial statements (consolidated accounts) in compliance with Business Accounting Standards or International Accounting Standards.
- Abridged annual financial statements may be prepared by entities which whose balance sheet amounts for the each of the last two consecutive years does not exceed two of the following three thresholds: (a) net turnover of LTL 7 million (approx. US\$ 2.7 million), (b) balance sheet assets total LTL 5 million (approx. US\$1.9 million), and (c) average number of 10 employees. Financial statements of these entities contain an abridged balance sheet, an abridged profit and loss account, a statement of changes in equity and abridged notes on the financial statements.
- That sample forms of full and abridged entity and consolidated financial statements are set out as examples in Lithuanian ‘Business Accounting Standards’ (BAS).

18. **In addition to annual financial statements, public and private limited liability companies shall prepare an annual report containing (a) a fair review of an entity’s’ position and performance, (b) a description of the development of the business, (c) a review of the main risks, (d) an analysis of financial and non-financial performance, (e) information about acquired shares (including own shares), (f) significant post balance sheet events, (g) the entity’s operating plans and forecasts, (h) information on research and development efforts, and (i) information on financial instruments.**

19. **According to the Law on Consolidated Accounts of Entities (Article 7), consolidated financial statements shall comprise a consolidated balance sheet, a consolidated profit and loss account, a consolidated cash flow statement, a consolidated statement of changes in equity, and notes to the financial statements.** The preparation of consolidated financial statements is mandatory for all public and private limited liability companies which have one or more subsidiaries irrespective of their location. Certain exemptions and simplifications to the law on consolidated statements are allowed as permitted by the EU Seventh Directive.

20. **Amendments to the Law on Financial Statements of Entities (No. X-1179), the Accounting Law (No. X-1178) and the Law on Consolidated Accounts of Entities (No. X-1180) were passed on June 7th 2007 by the Parliament of Lithuania.** All three amended laws

include a provision to allow for entities⁵ to choose to use either Business Accounting Standards or IAS/IFRS for keeping accounts and preparing financial statements (consolidated financial statements) for the financial year starting 1 July 2007 and later. It is expected that entities belonging to international groups will switch to IFRS and thus reduce their cost of doing business.

21. Certain entities are subject to laws issued by market regulators⁶ in addition to the more general accounting laws.

- Banks are required to submit their full set of financial statements required for regulatory reporting purposes to the Bank of Lithuania (which in addition receives a copy of the auditor's letter to management highlighting control weaknesses and other issues).
- The Insurance Supervisory Commission of Lithuania (ISC) requires insurance companies and pension funds managed by insurance companies to submit to them financial statements prepared in accordance with their regulations, as well as per the Law on Accounting. In addition, the ISC requires regulatory reports covering premiums and claims, liquidity of assets, and other data analyzed in detail.
- The Lithuanian Securities Commission (LSC) requires listed companies and other financial institutions (financial brokerage firms, investment management companies, undertakings for collective investment) under its supervision to provide audited financial statements and regulatory reports as well.

22. In the 2002 Lithuania ROSC, several instances where the Bank of Lithuania (BoL) regulations contradicted general purpose financial reporting for banks were noted. During this review, no instances of banking regulations contradicting or causing confusion with general purpose financial reporting requirements for banks were noted by any of the banks with which the ROSC team met. Banks' regulatory reporting to the Bank of Lithuania is based and anchored in their IFRS reporting and there appeared to be agreement and clarity in the reconciling items from one to the other. However, not all the information required for regulatory reporting purposes should necessarily be included in the general purpose financial statements. The Bank of Lithuania is to be commended on its progress since the previous report.

23. The Insurance Supervisory Commission of the Republic of Lithuania's (ISC) approach focuses on prudential reporting. Insurance companies are required to provide standardized forms of reports and, under certain circumstances, standardized calculations of technical provisions. As IFRSs are not allowed to be applied by non-listed insurance companies, and BAS is limited to insurance accounting, often prudential reporting requirements drive general purpose reporting requirements.

24. According to the Law on Securities, the Lithuanian Securities Commission (LSC) is responsible for the regulation of entities with listed securities. Recent amendments to the Law on Securities will reduce the number of entities subject to supervision by the LSC to approximately 60-70 companies. This represents a significant reduction in the scope of companies currently subject to oversight by the Securities Commission

⁵ This provision relates to limited civil liability profit-seeking legal persons whose securities are not traded on regulated markets. This provision excludes insurance companies from only using IFRS. As such, insurance companies prepare statutory financial statements in line with the Regulation N7 of the ISC and Business Accounting Standards (BAS).

⁶ These laws include the Law on Securities, Law on Banks, Law on Credit Union, Law on Financial Institutions, Law on Insurance, Law on Markets in Financial Instruments, Law on Collective Investment Undertakings, Law on Pension Fund, Law on Supplementary Voluntary Pension Accumulation, Law on Pension Accumulation.

25. The following table summarises the requirements:

Table 2: Corporate Financial Reporting Requirements

Financial statements Entities	Legal Entity and Consolidated Financial Statements	Changes to Laws Resulting From June 7th, 2007 Amendments
Listed⁷ public limited liability company	Reporting in accordance with endorsed ⁸ IAS/IFRS	Accounting and reporting in accordance with endorsed IAS/IFRS
Public limited liability company	Accounting and reporting in accordance with BAS; IAS/IFRS can be applied instead of BAS	Endorsed IAS/IFRS can be chosen for statutory purposes
Private limited liability companies	Accounting and reporting in accordance with BAS; IAS/IFRS can be applied instead of BAS	Endorsed IAS/IFRS can be chosen for statutory purposes
Small limited liability companies	Accounting in accordance with BAS. Abridged financial statements can be prepared. IAS/IFRS can be applied only instead of BAS.	Endorsed IAS/IFRS can be chosen for statutory purposes
Banks	Accounting and reporting in accordance with endorsed IAS/IFRS	Accounting and reporting in accordance with endorsed IAS/IFRS
Insurance companies	Accounting and reporting in accordance with Regulation N7 of the ISC and BAS; IAS/IFRS cannot be applied instead of BAS. Detailed accounting requirements are set out in regulations by the Insurance Supervisory Commission (ISC)	
Partnerships, Limited Partnerships, Individual Enterprises	Double entry accounting is required. Preparation of annual financial statements not required except in the case described below. Accounting in accordance with BAS is required only if entity decides or is required by law to prepare financial statements. Partnerships which are owned by public or private limited liabilities are required to prepare financial reporting.	

26. There are 46 companies⁹ currently listed on the regulated market of Vilnius Stock Exchange (VSE), a part of OMX¹⁰. The financial reporting requirements for such companies are in compliance with the EU Transparency Directive and all other EU legislation. Companies are required to make public an annual report within 4 months of the year end, a half yearly report within 2 months of the period end and to release quarterly financial statements¹¹; these reports

⁷ Here, 'listed' refers to entities with securities traded on a regulated market

⁸ In order for IFRS to be approved for use in the European Union, standards must be adopted by the European Commission, advised by the Accounting Regulatory Committee (ARC).

⁹ The 46 listed companies comprise approximately 7% of all public limited liability companies in Lithuania

¹⁰ OMX owns exchanges in the Nordic and Baltic region, and develops and provides technology and services to companies in the securities industry.

¹¹ These are called 'Interim Management Statements' in the Transparency Directive; Lithuania has implemented this requirement as quarterly reporting.

and financial statements must be released via an officially appointed mechanism which is accessible across the EU. Listed companies are also obliged to publish their financial statements in some form of mass media; most use their company website. Listed companies must also submit their financial statements to the SECR.

27. **OMX has also recently launched a junior market in Lithuania, which is not a regulated market as defined by the EU Markets in Financial Instruments Directive.** This market is expected to operate in the same way as the secondary Alternative Investment Market (AIM) does in the United Kingdom and will be for smaller, potentially more risky, companies. These companies will be subject to regular reporting requirements, but will not be required to report using IFRS.

28. **According to the Civil Code (Article 2.66) entities' annual financial statements, audit report and annual report shall be submitted to the State Enterprise Centre of Registers (SECR) every year within thirty days of their approval.** The Law on Companies (Article 58) states that the financial statements must be approved by the shareholders at the general meeting of shareholders within 4 months of the year end. Most companies select December 31 as their year end date, which results in auditors having to perform the majority of audits from December 31 until March 31 each year. This requirement that audits must be completed and financial statements approved in such a short amount of time may greatly affect the resulting level of quality of financial statements. Many EU member states adopted longer timeframes for the approval of financial statements for non-listed companies. It is recommended that Lithuania extend the period that non-listed companies are allowed between year end and financial statement approval. In looking to modify this law, Lithuania should look to peer countries for relevant examples.

29. **Since 2005, companies have been required to file their annual financial statements only with the SECR; prior to this, the collection of financial statements was the responsibility of the tax office and copies of financial statements were also required to be sent to other government offices¹².** Currently, companies have the ability to submit annual financial statements and accompanying documentation either in paper form, scanned paper form or online using standard forms¹³ (with scanned notes) to the SECR. All filed company information is publicly available and can be obtained from the SECR for a nominal fee. Listed companies must also submit their annual financial statements to Vilnius Stock Exchange and the LSC both in paper and scanned form in both Lithuanian and English. The financial statements of listed companies are available on the LSC and OMX websites. In addition Lithuania's National Statistics Office requires that companies provide selected financial information by completing their annually and quarterly prepared questionnaires.

30. **There are approximately 64,000 registered legal entities that are legally required to submit annual financial statements to the SECR.** However, according to the SECR database, only approximately 60% of companies had submitted financial statements for the year 2006. The SECR stated that some of those not filing were probably inactive companies still on the register and that by May 2007 the compliance ratio for submission of 2006 reports had increased to roughly 70%.

31. **The SECR is not currently able to effectively enforce the requirement for companies to file financial information in a timely manner.** The SECR Administrator has the right, but is not obliged to perform investigations of late or non-submission. The SECR has the right to fine companies for late submission and to close down a company for failure to submit financial information two years after the deadline. However, little enforcement is currently

¹² For example, financial statements also had to be submitted to the National Statistics Office.

¹³ This option was created in 2006 and allows companies to use a pre-designed electronic format for submitting financial information.

undertaken as the current system is new and companies are being given some allowance to get used to complying with it. The financial information filed with the SECR is only reviewed administratively; it is not reviewed for compliance with BAS/IFRS or for the type of audit opinion given.

32. **Although the SECR currently allows both paper and on-line submission of financial information, the SECR has been contemplating only allowing the submission of financial information using these electronic pre-defined formats (which would include a computer check of entered data).** This idea may be welcomed by very small entities, which may try to use the system for producing their financial statements, and it may be useful for statistical purposes. However, for many companies such forms would be difficult to use to produce primary financial statements compliant with BAS or IFRS. Such standard formats risk separating primary statement information from key disclosures in the notes to the statements and may, as a result, distort the entity's financial statements such that they do not show a true and fair view of an entity's financial performance¹⁴ and condition.

33. **Submission of data in pre-defined formats is in part driven by the country's statistical and taxation reporting needs.** The use of pre-defined formats for the collection and presentation of financial statements can be acceptable for financial reporting if these formats are sufficiently flexible to allow for different company types and the presentation of complex financial information. Currently, the pre-defined formats permitted by the SECR may not be adequately flexible to allow for special financial reporting considerations. As such, it may be advantageous to allow parallel data collection or input from entities which do not limit the presentation of financial information for public reporting purposes. Full financial statements (of which notes are an integral non-divisible part) should be prepared on the basis of the BAS or IFRS without rigid requirements set by predefined formats.

34. **There exists in Lithuania, as in many peer countries, confusion amongst practicing accountants who still view tax accounting as the primary purpose for preparing financial statements and often lack a clear understanding of the differences in requirements of BAS or IFRS as against taxation regulations.** Consistent anecdotal evidence and the outcome of the financial statement review in section III support this view that many preparers of financial statements struggle to understand the key differences between general purpose accounting under BAS or IFRS and accounting for taxation purposes. This influence of taxation on financial reporting is stronger in small and medium size entities where managers and chief accountants are afraid to show the fair value of assets (e.g. inventories at net realizable value, economic depreciation rates, present value of receivables, etc.) in order not to trigger tax investigations on the differences between their accounting and tax results. Often the 'tax numbers' are simply inserted into a standard chart of accounts to produce the general purpose financial statements. In larger companies (especially those linked to foreign capital) the effect of taxation on financial reporting is not an issue and accounting is treated separately from tax calculations. Nevertheless the notes to the financial statements should include the differences between accounting and taxable income. In practice larger companies use more detailed sub-accounts (splitting costs and revenues by taxable and non taxable) in their existing accounting records to support the tax calculations.

35. **Small and Medium-sized Entities (SMEs) in Lithuania follow the requirements of the Law on Accounting and apply Lithuanian Business Accounting Standards (BAS) or IFRS.** As noted above, such entities are allowed to prepare abridged financial information. In addition to companies there are almost 70,000 entities including general partnerships, limited partnerships or individual (private) enterprises (which can also be treated as SMEs) which are not under an obligation to draw up financial statements.

¹⁴ Distortions may stem from electronic standardized financial statements being a completely new and un-audited set of financial statements and the fact that users may be misled by abridged information.

A.2. The Statutory Framework for Auditing

36. **The requirement for the statutory audit of an entity is defined in the Law on Financial Statements of Entities (Article 19¹).** The annual financial statements of public limited liability companies, insurance companies¹⁵ and state-owned and municipal enterprises must be audited. For private limited companies and for general partnerships and limited partnerships, (where all participants are either public limited liability companies or private limited liability companies), if the entity exceeds at least two of the following indicators on the last day of the reporting period: annual net turnover of LTL 10 million (approx. US\$3.91 million), total balance sheet assets of LTL 5 million (approx. US\$ 1.95 million), and an average number of 10 employees, it must be audited. The Law on Consolidated Accounts of Entities (Article 10) requires the annual audit of all consolidated financial statements...

37. **The Lithuanian requirement for statutory audit is compliant with EU legislation governing statutory audit as it requires all companies with limited liability (with the aforementioned exceptions for smaller companies) to be audited.** The EU sets maximum limits on the size criteria for 'small' companies but member states can set smaller size criteria if appropriate for their state. Lithuania currently utilizes thresholds to allow exemptions to small companies where an audit may not be necessary to protect the public.

38. **The Law on Audit governs the conduct of audit in Lithuania.** It sets out provisions for approval and registration of auditors and audit entities, and sets requirements for auditors' ethics and independence, continuing education, the applicable standards for auditing (it allows use of National or International Standards), quality control and the activities of the Lithuanian Chamber of Auditors (LCA).

39. **A new draft of the Law on Audit, which will implement recent amendments to the EU Eighth Company Law Directive (the 'Eighth Directive') governing audit, has recently been prepared. It was drafted by a working group which was led by the Lithuanian Ministry of Finance with all the major regulators represented.** The draft has recently been provided to professional organizations and the AIL for comment and extensive comments have been prepared, in particular by the LCA. There is currently considerable debate relating to the provisions of the draft Law. It is extremely important for the maintenance of the reputation of the audit profession that agreement is reached on the main points of contention, if possible while the Law is in the draft stage. All interested parties should meet to discuss and find agreement on the main issues.

40. **The debate centers on the key amendment introduced by the changes to the Eighth Directive, the introduction of public oversight of the audit profession.** The draft Law on Audit introduces a public oversight body (it proposes the existing Accounting Institute of Lithuania (AIL) in a changed form) which will have ultimate responsibility for tasks such as registration and quality control of auditors.

41. **The capacity of the proposed public oversight body should also be considered.** The AIL appears to have expertise which is ideal for the role of high-level oversight of the regulation of the audit profession.

42. **The Law on Audit requires auditors to comply with the Auditors' Code of Professional Ethics and sets out independence requirements for auditors.** These independence requirements prohibit auditors from providing non-audit services to audit clients. These services include preparation of financial statements, property and business valuation services, performance of the client's internal audit, design and implementation of financial

¹⁵ The requirements for insurance companies are further detailed in the Law on Insurance which states that all insurance companies, irrespective of size, are required to have their annual financial statements audited.

information technology systems, and representation in dispute settlement. The exception to this is if the audit company has expressly demonstrated that the provision of the services has not had any impact upon the independence of the audit company; this may be difficult to demonstrate in practice.

43. **The Law on Audit (Article 35) also requires mandatory rotation of auditors every 5 years, shortened to 3 years for audits of financial institutions per the Law on Financial Institutions (Article 45).** The EU Eighth Company Law Directive requires key audit partner rotation a maximum of every 7 years; the Lithuanian requirement goes beyond this legislation. Some auditors in Lithuania consider that such frequent rotation, particularly for financial institutions, is inefficient as new audit teams need additional time to understand the client's business and internal controls. Concerns have also been expressed by audit clients, for whom frequent changes in the audit team require additional time and effort during the audit process. Although frequent rotation may present challenges, the National Bank notes the importance it has in furthering auditor independence, especially considering the size of the country and the market.

44. **The Law on Companies (Article 19) states that audit firms shall be selected, dismissed and have their remuneration set during the general meeting of an entity's shareholders.** According to the Law on Audit (Article 32) the auditor shall be held liable under law for presenting a fraudulent auditor's report and for performance of the audit per the audit contract. The auditor and audit firm must compensate the audit contractor, the audited enterprise or any third party for any losses incurred by them in accordance with the procedures set out by law. Auditors and audit firms must take out third party liability insurance with a minimum annual amount of LTL 100,000. Contractual limitations of auditors' liability may exist in practice, although this area is not regulated by law as it is in many other countries. There have been some recent cases where auditors have been held liable for such damages in Lithuania, but previously such cases were very rare.

45. **The Law on Audit (Article 28) requires additionally that auditors must not have property obligations to the institution being audited, not be closely related to any owner of a qualifying holding in the authorized capital and/or voting rights of the institution being audited, and not be influenced by other conditions which may affect his/her independence.** Audit firms must ensure that the annual income received from one client does not exceed 20 per cent of the total income received by the audit firm for 2 successive years. The relevant supervisory institution may make the decision to prohibit institutions from obtaining audit services from audit firms which do not meet these requirements.

46. **Auditors of public interest entities (PIEs), including insurance undertakings, are required to have at least three years of experience in performing audits.** The same auditor may not audit the same insurance undertaking for more than five years in succession, and not thereafter for two years.

47. **Companies whose securities are being traded in a regulated market, financial brokerage firms, fund management companies and investment companies with variable capital must obtain the approval of their auditors from the Securities Commission each year.** This approval must be obtained before the audit can be performed. The local member firms of the four largest international audit firms currently audit all but one of the listed companies in Lithuania. The audit of the exception was recently won by a local audit firm and approved by the LSC. If a regulated company wishes to replace their auditors, the new candidate auditor shall be submitted to the relevant regulator for approval, together with an explanation of the reasons for such a replacement. Similarly, insurance companies are required to seek approval for their choice of audit company/individual auditor from the ISC within 10 days of selecting their auditor.

B. The Profession

B.1. The Accounting Profession

48. **The number of professional accountants in Lithuania is not easy to accurately define as there is no formal, organized accountancy profession. In fact, it can be challenging to translate the term ‘accountant’ in Lithuanian; the most often used term is ‘Buhalteris’, which is often translated back to English as ‘book-keeper’.** Company staff that fulfil many of the roles which would be typically fulfilled by professional accountants in other countries, such as the UK, are often titled ‘financial managers’. However, in most companies there is a role titled ‘chief accountant’; the chief accountant is generally responsible for the preparation of the entities’ financial statements and for other financial reporting such as internal management accounting. These chief accountants are the accounting profession in Lithuania. However, the chief accountants are not organized into representative professional organizations and generally do not have a formal professional qualification; many received their training and education under the previous regime and system.

49. **There is one professional organization of accountants and auditors in Lithuania, the Lithuania Association of Accountants and Auditors.** Established in 1989, the association currently has 125 active members. The association offers a professional qualification comprising 4 examinations comprising taxation, accounting, law and computer literacy. 650 accountants have gained the qualification, but only 125 remain as members of the Association; the Association has lost touch with up to 200 of the remainder. The Association estimates there to be up to 15,000 potential members (i.e. professional accountants) in Lithuania. It admits that the Association has not been able to sufficiently market itself in the past and is working to remedy this. The Association is not a member of IFAC, but has recently developed a Code of Ethics for its members based on the IFAC Code of Ethics, which it hopes to soon publish and promote.

50. **After 16 years of independent development in Lithuania, the organized accounting profession, as represented by the professional organization, has only a tiny membership which makes up less than 1% of the estimated total of Lithuanian professional accountants; this illustrates a major challenge facing the profession.** The inclusion of more accountants with the organized profession in Lithuania is restricted by a number of factors. First, there is little market recognition of, or demand for, membership of such a professional body. Many of the employers which the ROSC team met did not indicate that such membership of a professional body was a necessity for consideration for employment as a chief accountant. Most even said that such membership would not benefit any applicant. The second major factor, which is related, is the inability of the professional organization to attract accountants into membership

51. **The professional organization is attempting to address both these factors. Through the promotion of its Code of Ethics it hopes to demonstrate to employers the benefits of employing accountants who are its members.** It also is hopeful of working with employers organizations and if possible the government to seek public, though not legal, endorsement and recognition of the organization’s goals and the benefits of membership. The organization is also seeking to market itself to potential new members. One step towards this is a plan to stratify membership of the professional organization into three qualification levels: i) bookkeeper, ii) professional accountant and iii) expert accountant. The Association has been working with Vilnius College to assist in the setting of the bookkeeping examination.

52. **Very few Lithuanians have taken international English-language accountancy qualifications such as the ACCA or US CPA.** Even the large international network accountancy firms only occasionally sponsor their staff to complete such qualifications. As a result of the very small numbers of accountants who hold professional qualifications, either from the Association or other qualifications, many accountants have received little or no training (other than to a limited degree at university or college) in modern, internationally recognized

accounting techniques and financial reporting. As a result, while Lithuania has adopted Business Accounting Standards based on IFRS, many preparers struggle to understand and implement their requirements. Bookkeeping and financial reporting are often conducted according to the tax rules and concepts commonly used in the past. Principles-based accounting standards such as BAS and IFRS require interpretation and accounting estimates and are very different from the previous strictly regulated rules-based environment. The capacity of preparers of financial statements, and with it the quality of financial reporting, depends on improving the ability of all Lithuanian accountants to understand and apply the principles and concepts put forward in BAS and IFRS.¹⁶

53. **Educating ‘chief accountants’ who work at the majority of Lithuanian companies is key to improving the practical application of BAS, IFRS and principles-based accounting.** While the level of understanding of modern accounting concepts of recent graduates may be higher than that of current accounting practitioners, the established accountants should be also given an opportunity to improve their theoretical and practical skills. The inclusion of a much greater proportion of the accountants in Lithuania within a professional organization would help the accountants gain this training and education and would also provide a voice for the profession to be represented in important debates.

B.2. The Audit Profession

54. **The Lithuanian Chamber of Auditors (LCA) regulates auditors in Lithuania. The Chamber was established under the provisions of the first Law on Audit of the Republic of Lithuania in June 1999¹⁷ as the regulatory body for the Lithuanian audit profession – it acts both as a regulator and as a representative body for auditors.** It is an independent, self-governing association and, as of November 2006, has 403 auditors as members and registers 208 audit firms in Lithuania. Approximately 62% of the auditors work in public practice; the remainder work in industry, government and education. The LCA is managed by a President and an 8-member Presidium, which are elected by the General Meeting of Members, and has 4 full-time employees. The President works part-time. The LCA’s main activities currently include:

- Preparation of the National Standards on Auditing, the Code of Auditors’ Professional Ethics and other audit methodology
- Organization of the qualification examination for auditors and issuance of auditor’s certificates
- Organization of training of auditors and establishment of training requirements
- Supervision of activities of auditors and audit firms
- Approval and registration (and de-registration) of auditors and audit firms in the List of Auditors and Audit Firms.
- Protection and representation of auditors’ interests at the State authorities and Government institutions
- Submission of proposals for legal acts regulating audit and accounting

55. **To become a certified professional auditor and to obtain membership in the LCA are one in the same as membership in the LCA is compulsory for all certified professional auditors and only certified auditors are members of the LCA.** Individuals interested in obtaining professional auditor certification/LCA membership must be a Lithuanian citizen or a

¹⁶ It is important to note, that, in general, the situation is somewhat better in the financial sector, when compared to the other parts of economy.

¹⁷ The Audit Law passed in April 2004 confirmed the LCA’s current role and responsibilities.

citizen of another European Union Member State, have a good command of the Lithuanian language¹⁸, are required to have obtained a university degree¹⁹, completed 150 hours of test preparation courses provided by the LCA which cover the general subject areas covered on the exam and completed three years of professional experience as an auditor's assistant with an audit firm prior to sitting for the LCA professional certification examination.

56. **The certification examination consists of five exams which cover (1) accounting and financial analysis, (2) audit, internal audit, international and national standards on auditing, (3) taxation, (4) legal acts regulating the activities of enterprises, and (5) economics, finance management, mathematics and statistics.** An individual is considered to have passed the exam if he/she scores at least 65 out of a possible 100 points. After failing the examination, a person may attempt to pass the examination after a six month period. The number of attempts an individual may take at passing the exam is unlimited.

57. **Overall, the number of individuals passing the LCA professional auditor certification examination is low, however, recent efforts to incorporate mandatory test preparation courses and the relaxation of laws requiring applicants to have obtained a university degree in economics led to a dramatic increase in passage rate and the number of auditor's certificates issued in 2006.** After passing the exam, applicants are admitted to the profession if they are found to be of good repute and have been sworn in.

58. **Once admitted to the profession, certified auditors are required by law (Law on Audit Article 30, 1.6) to obtain 120 hours of continuous professional development (CPD) every 3 calendar years.** CPD courses are provided mainly by the LCA but sometimes the LCA allows third party providers to conduct CPD. CPD courses typically cover topics such as national and international standards on auditing, internal audit, auditor's professional ethics, international accounting (financial reporting) standards, the legal acts of the Republic of Lithuania regulating audit and auditor's activities, tax laws, etc.

59. **The LCA is an associate member of IFAC, the International Federation of Accountants, and a correspondent member of FEE, the European Federation of Accountants.** As an associate member of IFAC, the LCA is committed to making its best endeavors to comply with IFAC's Statements of Membership Obligations (SMOs), which are best practice requirements for professional accounting and auditing organizations. The SMOs include regulations on quality control of members' work, systems of investigation on discipline for members and educational requirements.

60. **The Law on Audit requires auditors to use either National or International Standards on Auditing.** The LCA sets the National Standards based on International Standards, and also published the International Standards on Auditing in Lithuanian in 2005. The LCA prepares audit methodology to support the application of the National and International Standards on auditing and employs an Audit Methodology Specialist as one of the four full-time staff of the LCA.

61. **The LCA sets a Code of Auditors' Professional Ethics which is based on IFAC's Code of Ethics.** Compliance with the Code is mandatory for all auditors. In addition, the Law on Audit contains some requirements with regard to auditor's independence and the new draft Law on Audit will address independence as noted above in Section IIA. Compliance with ethical requirements are enforced by the LCA's quality control of auditors.

¹⁸ Although the LCA does not require that applicants pass a language proficiency exam, the LCA professional auditor certification exam is only offered in the Lithuanian language.

¹⁹ In 2006 legislation requiring that only individuals with a university/college degree in economics could sit for the certified auditor examination and be admitted to the profession was repealed.

C. Professional Education and Training

62. Professional accounting education and training in accountancy and auditing in Lithuania is needed by all participants in the corporate financial reporting process.

Different levels and types of competence are required by different participants; preparers of financial statements need a good working knowledge of the standards to which they must prepare financial statements, which is currently either Business Accounting Standards (BAS) or IFRS. Bookkeepers need knowledge of only the basics of the accounting system they use; auditors need a higher level of knowledge and skills to cover auditing standards and techniques in addition to accounting standards; regulators need specific knowledge of the law and regulations relating to financial reporting in their field; and taxation officers need to know both the taxation regulations and the interaction between the taxation regulations and accounting principles used to prepare financial statements. Education and training in accountancy is delivered through four mediums – the university education system, private companies which provide basic accountant training, professional certification, and professional development courses organized by professional organizations.

63. Accountancy and audit education is offered at universities, colleges and business schools in Lithuania, both as part of economics degrees and as specific accounting degrees.

Universities do not appear to have any difficulties recruiting students for business and economics degrees, and many of these students take accountancy courses. Such courses' curricula generally include teaching Lithuanian Business Accounting Standards (BAS) and also cover, to a lesser degree, IFRS. The accounting courses' syllabi are constructed to be in compliance with the EU-wide degree content review process (the 'Bologna process') and include subjects such as financial and managerial accounting, audit, taxation, international accounting, accounting history, financial analysis and corporate activity. Although the overall quality of university accounting education is perceived to be good, many universities are resource-constrained and do not have the means to send their professors to training seminars and refresher courses to ensure that their professors' qualifications and knowledge of accounting and auditing is up-to-date. In addition, there is a lack of accounting textbooks and teaching materials available in the Lithuanian language. This hinders the effective teaching of up-to-date accountancy and the transfer of knowledge from professors to students. In order to overcome some of these challenges Lithuania's university and college accounting departments have recently come together to establish The Lithuanian Association of Educators and Researchers of Accounting, a consortium of university and college level professors and accounting departments. The main purpose of this organization is to enhance and standardize the level of accounting education nation-wide.

64. Although some universities incorporate work experience into their curriculum through internships and work-study programs, concerns have been raised over the lack of emphasis that university and college-level accounting programs place on the development of practical accounting and auditing skills, which are many times more valued than accounting and auditing theory in the workplace.

This leads to a 'gap', acknowledged by students, lecturers, and employers, between the level of students' education upon leaving the university and the skills required of an accountant in the workplace. To help to lessen this 'gap', the interaction between institutions of higher learning and businesses/audit firms in the private sector should be strengthened to better assist universities and colleges in constructing curricula which provide graduates with the practical accounting and auditing skills necessary to succeed in the workplace. Currently, the Lithuanian Ministry of Education is reviewing and reforming the country's tertiary education system. Focusing particular attention on the reform of university and college level accounting programs through the Ministry of Education's overall review of university education may be an ideal way to enhance the education and training of accountants and auditors.

65. The range of professional accounting education and training available currently in Lithuania includes:

- Accounting courses offered by private sector training providers. The topics covered in these courses range from basic accountancy training for recent college graduates and individuals interested in changing careers to more advanced subjects for accountants already employed by companies.
- Courses organized by the Lithuanian Chamber of Auditors to prepare potential candidates for the audit qualification exams, as well as continuous professional development courses for certified auditors.
- Seminars and training arranged by the Lithuanian Accountants and Auditors Association to prepare candidates for their professional certification examinations and to enhance the continuous professional development of their organization's certified members.
- Training courses and seminars provided by the large (Big 4) auditing firms for their employees.
- Study toward the English-language ACCA qualification. The qualification typically takes 3-5 years to complete, is relatively expensive and requires good command of the English language. As such, few individuals pursue this form of certification.

66. The qualification, professional experience and CPD requirements mandated by the Chamber of Auditors appear to be in conformity with the European Union Eighth Directive and the IFAC International Educational Standards (IES). However, the Chamber's rules regarding the provision of CPD appear restrictive in practice as the Chamber of Auditors currently recognizes only a few non-Chamber sponsored trainings and seminars as acceptable for meeting their CPD requirements. This results in a lack of choice in providers and market competition in the provision of CPD courses for auditors, which may result in CPD of lower quality. The Chamber of Auditors should be more accepting of the provision of quality CPD courses by third parties in order to enhance the variety and quality of professional training through market competition.

67. The accountancy profession is not as well developed as the auditing profession; professional education and training in accountancy, which are more typically provided through professional associations elsewhere, are being provided by private sector accountancy education and training companies. The professional organization for accountancy has a small membership at present. It should seek to work with the providers of professional accountancy training to include more accountants in membership, and thus in the formal accountancy profession over time.

68. Professional organizations and the private sector (companies and accounting service providers, and audit firms) should be encouraged to work more closely with universities and colleges to enhance the quality of the accounting training provided. The Lithuanian Association of Educators and Researchers of Accounting would be the ideal university side counterpart for building this working relationship. Through the coordination of syllabi and subjects taught, professional associations may be able to offer exemptions from parts of their professional examinations to students. The availability of such exemptions reduces the length of time and cost of completing subsequent professional qualifications, and thus increases training capacity. It also enhances the attractiveness of joining the professional organization. In addition, there is a need to enhance the resources available to university faculties teaching accounting, both in terms of updating the skills and knowledge of faculty staff and in the provision of textbooks, training materials and reference materials, such as local-language copies of BAS, IFRS, ISAs, etc.

69. **Existing participants in the financial reporting process should be encouraged to gain the education and training they need to meet the requirements made of them in their role.** This covers preparers in all sizes of entity, regulators, auditors and even taxation officers; in almost all cases, this means expanding and re-training their knowledge and skills in Business Accounting Standards (BAS) and laws, some will also need to study IFRS. One way of ensuring this could be through the Ministry of Finance's participation in developing, recognizing, and supporting the professional accountant certification examination provided by the Lithuanian Association of Accountants and Auditors. Currently, this association is working to develop three levels of certification which would differentiate individuals as book-keepers, professional accountants and expert accountants based on professional experience and passage of professional examinations. By providing assistance and supporting this association's efforts to encourage voluntary certification, the Lithuanian government could increase the amount of certified accounting professionals and their continuing development, as the Lithuanian Association of Accountants and Auditors would oversee their members' fulfillment of CPD. The Lithuanian government, regulators, professional bodies and education providers should work together to decide on appropriate target educational standards and qualifications suitable for rapidly expanding Lithuania's accounting capacity.

70. **Continuing Professional Development (CPD) is required for auditors by the Lithuanian Chamber of Auditors (an associate member of IFAC).** IFAC-member professional bodies are required to promote and facilitate CPD as part of their membership obligations.

71. **From discussions with representatives of commercial banks, insurance companies, investment firms, and leading industrial companies, it was clear that the current training offered on IFRS and changes in IFRS is not sufficient.** Although there are a number of private sector companies providing accounting education and training, these companies tend to focus on Lithuanian BAS and not IFRS. Therefore, a lot of IFRS knowledge is obtained through self-study. The provision of IFRS training needs to be enhanced.

D. Setting Accounting and Auditing Standards

72. **The Accounting Institute of Lithuania (AIL) is responsible for setting national accounting standards, referred to as Business Accounting Standards (BAS).** New standards, or amendments to existing standards are produced, approved by the AIL's Accounting Standards Board and published in the official gazette of the Republic Of Lithuania. The Accounting Standards Board votes on prepared drafts of standards prior to their approval by the director of the Accounting Institute. The Board consists of three members from the Accounting Institute, two from the Chamber of Auditors, and one from each of the Lithuanian Accountants and Auditors Association, the Securities Commission, the Insurance Supervision Committee and the Ministry of Finance. Members of the Board are not remunerated.

73. **BAS is based on IFRS. However there are a few differences between the frameworks; these are analyzed in section III below.** The Accounting Institute issues guidance on application of BAS.

74. **The Law on Audit allows the use of National or International Standards on Auditing. The Audit Committee of the Lithuanian Chamber of Auditors (LCA) prepares and evaluates Lithuanian National Standards on Auditing (NSA).** The Committee holds a period of public consultation then submits amended standards to the LCA Presidium for approval. Finally, the LCA General Meeting then approves the standard. The Audit Committee is also responsible for coordinating the translation of International Standards on Auditing (ISA), commenting on both sets of standards and developing other audit methodology. 32 National

Standards on Auditing have been approved; eight have recently been revised. The main principles and guidance of the NSA are based on ISA. However, the LCA states that two NSA are ‘more specific’ than their ISA equivalents: NSA 2 “Terms of Audit Engagements”, and NSA 13 “The Auditors Report”.

75. **The General Meeting of the LCA had debated at length the adoption of ISA as the National Standards on Auditing at each of the last few years’ meetings. During its 2006 General Meeting, the LCA approved the use of ISAs and the decision to transition to these standards by 2009.** The review of the differences in the standards (ISA versus NSA) in Section IV indicated that the differences between the two were not major as NSA are based on ISA. However, there appear to be a small number of important standards and requirements in ISA which do not have equivalent NSA standards or requirements. It appears that the adoption of ISA will be an improvement of the current situation as it will enable international observers to be more confident in the quality of audit in Lithuania.

E. Enforcing Accounting and Auditing Standards

E.1. Enforcing Accounting (Financial Reporting) Standards

76. **A proper and rigorous enforcement regime for financial reporting is key to establishing and maintaining the quality of financial reporting and to underpinning investors’ confidence in financial markets.**²⁰ The 2002 ROSC report noted that, although the Securities Commission had the legal power to enforce or monitor compliance with IAS or BAS, due to a lack of sufficient staff with necessary skills it did not undertake any systematic work in this area. Some progress has been made since that report, but the enforcement regime in relation to compliance with accounting standards is not yet operational and the department still suffers from a lack of appropriately qualified personnel.

77. **The Law on Securities authorizes the Securities Commission to review financial information produced by issuers.** Following amendments to the Law on Securities, the Securities Commission expects that approximately 60-70 companies will be within their scope. This represents a significant reduction in the scope of companies currently subject to oversight by the Securities Commission and should assist in the process of getting an effective enforcement regime operational.

78. **A distinctive characteristic of Lithuanian financial statements is the number of qualified audit reports; according to the Lithuanian Chamber of Auditors, approximately 38% of audit opinions were qualified in 2005.** This indicates that companies are not concerned by the receipt of a qualified audit report and reflects the lack of active accounting enforcement which could require companies to change their accounting treatment to comply with relevant standards.

79. **Significant work has been done by the Securities Commission in the area of risk-based selection of companies for review.** The identification of the financial statements to be reviewed on the basis of risk posed to the market is an important step towards Lithuania being in a position to comply with its responsibilities to review financial information of issuers under the Transparency Directive and in accordance with CESR Standard No 1. However, the risk-based selection system should be developed to reflect the relatively small number of listed issuers in Lithuania. This report supports the development of such a risk-based selection system in the medium- to long-term, however, in the short-term this report recommends that resource is focused on identifying and reviewing those financial statements of issuers that have received a qualified audit report. Where the company has received a qualified audit report, the Securities

²⁰ Recital 16 of EC directive 1606/2002, otherwise known as the IAS Regulations

Commission should write to the company to ask them to justify why, with references to relevant accounting standards, they have adopted the particular accounting treatment that is not supported by the auditor. A similar letter asking for justification of the auditor's position should be sent to the audit firm. These two technical positions can be analyzed against each other and, with the support of EECs²¹ if necessary, the Securities Commission will be able to decide whether the company's treatment is appropriate and in compliance with accounting standards. This approach will also help to train staff

80. **There is significant concern about whether the Securities Commission could attract the staff and resources necessary to enable it to carry out effective enforcement and monitoring of compliance with IFRS.** Article 24 of the EU Transparency Directive states that Member States may allow the Competent Authority, in this case the Securities Commission, to delegate the responsibility to examine financial information for compliance, and to take appropriate measures in the case of discovered infringements. Consideration should be given to a system whereby the Securities Commission identifies the financial statements to be reviewed and passes the statements to another competent body to perform the detailed review. Where appropriate, cases are referred back to the Securities Commission for appropriate enforcement action. Such a system would have the benefit of allowing the Securities Commission to use their detailed knowledge of issuers when selecting financial statements for review, at the same time allowing the reviews to be performed by the body where there is the greatest current concentration of knowledge of international accounting standards.

81. **For companies that do not fall within the definition of issuer, there are three main concerns: first, the level of compliance with filing requirements is relatively low (approx. 60% of registered companies filed financial statements in 2006); second, the use of standard forms for filing financial statements encourages a mentality which may be inconsistent with compliance with accounting standards; and third, there is no body that is responsible for ensuring that such financial statements comply with BAS (or IFRS if the company chooses to report using international standards going forward).** The SECR has only recently been given responsibilities for monitoring and maintaining filings by companies and has made substantial progress over this short period of time, but there remains much to be done in this area.

82. **The provision of publicly available financial information on non-listed companies is important even though the number of stakeholders in each non-listed company may be less than in listed companies. In total, non-listed companies represent a much larger share of the economy and many more stakeholders than listed companies.** At present there is a small fine which could be imposed for the non-submission of financial information to the SECR, but fines are not currently imposed. There are many companies would rather simply pay the fine than publicly disclose information that they believe could provide competitors with commercially sensitive information. In order for a public disclosure regime to be effective and compliant with the recently amended EU First Company Law Directive, the fines for non-disclosure must be significant and must be imposed.

83. **The payment of a fine should not remove the obligation on the company to submit the relevant filings.** This report recommends that the payment of the fine should be in addition to the continued requirement to file information. Furthermore, this report recommends that the fine should increase in proportion to the period of non-submission; continued non-submission would lead to an ever-increasing fine. If a company has not submitted financial statements for two years this report recommends that the company should be required to either submit a notice that the company is dormant (and therefore not trading) or it should be struck off the register and the directors made personally liable for the debts of the company.

²¹ The European Enforcement Co-ordination Committee. This is not a decision making committee, but could offer advice on difficult cases.

84. **This report recommends that there should be a body appointed to respond to complaints about financial statements which fall outside of the scope of the Securities Commission.** This body could be the SECR, but this report acknowledges that there may not be sufficient knowledge of BAS in that entity at present and such work may better be performed in conjunction with other experts. This report does not recommend that a systematic review regime be put in place for these companies, but it is important that there is a mechanism through which companies can be required to amend their financial statements where there is an upheld complaint. It is important that some enforcement be implemented in this area to encourage compliance by what is by far the majority of companies in Lithuania (i.e. non-issuers).

E.2. Enforcing Auditing Standards

85. **Enforcing auditing standards contributes to ensuring audit quality which in turn can add credibility to published financial information and act as an important protection mechanism for shareholders, creditors and other stakeholders.** The Lithuanian Chamber of Auditors (LCA) is responsible for monitoring and enforcing compliance with auditing standards by the statutory auditors it supervises.

86. **The current system of audit quality control is carried out through a process which is the ultimate responsibility of the Audit Quality Control Committee (AQCC). This committee is administered by the LCA but is not part of or controlled by the LCA.** The Committee has nine members; three are nominated by the LCA, one member is nominated by each of the Ministry of Finance, the Bank of Lithuania, the Lithuanian Securities Commission, the Insurance Supervisory Commission, organizations representing entrepreneurs and organizations representing academics. Thus the committee has a majority of non-practitioners. The Ministry of Finance appoints the Chairman of the Committee and approves its composition.

87. **The LCA commenced the current program of quality control reviews of the auditors it supervises in 2002.** The Law on Audit requires that all auditors be subject to inspection at least once every 5 years (the minimum EU requirement is every 6 years). All auditors who have not yet been inspected under the program will be visited in the current year. The program is based on monitored peer-reviews of audit firm by quality control inspectors, who are auditors registered with the LCA. Inspectors undergo training on inspection methodology by the LCA and cannot inspect fellow auditors from their own region of Lithuania. There is a perception that the program is in its early stages and is 'on a learning curve'. Some of the larger audit firms express a concern that some of the inspectors are more competent than others and that some of the smaller audit firms or sole practitioners are subject to lower quality requirements.

88. **The Lithuanian Government should also considering increasing its focus on risk-based inspections in developing its system of quality assurance.** The information on the annual return forms provided by each auditor and audit firm should be automatically analyzed to assess the level of risk of potential quality problems; increased risk should lead to an early inspection. For instance, if the audit firm indicates it has recently taken on its first audit, or a new audit, of a listed company or a financial institution, then the firm should be flagged as a high-risk case and an early inspection scheduled. This scenario has recently occurred in Lithuania, where a local audit firm has recently taken on a listed company audit; however, the AQCC had no plans to visit the firm outside of the regular 3-year cycle for auditors of listed companies. Similarly, unsatisfactory outcomes of inspection visits should lead to automatically shortened cycles, normally revisiting within one or two years. The Lithuanian Government should work to ensure that the body responsible for audit quality control maintains the right to publish unsatisfactory inspection outcomes, which often encourages compliance.

89. **A standardized format, work program and scope of inspection visits should be developed so that the consistency of visit outcome can be relied upon.** The outcomes of inspection visits must lead to appropriate and consistent action. The goal of audit quality control

should not be to punish firms, rather firstly, to protect the public from inadequate quality audit and, secondly to promote improvements in audit quality by all auditors. Where significant deficiencies are found, licenses should be suspended conditional on improvements and re-training. Discipline cases should be reviewed to determine if removal of an auditor's certification is necessary. Where less significant deficiencies are found, a range of measures should be developed to encourage improvements, such as requiring targeted training, the adoption and application by the auditor of a standard audit methodology and other remedial action. Where such improvements are not confirmed by a subsequent inspection, the auditor's license should be suspended or removed. The removal of auditors from the register of auditors who are not able to perform audits to the required standard, and the improvement in the standard of work of those that remain will over time improve the quality, and the perceived quality, of statutory audit in Lithuania.

III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

90. **The purpose of this section is to analyze the significant differences between Lithuanian Business Accounting Standards (BAS) and IFRS (the 'standards gap'), the compliance of statutory financial statements with IFRS and BAS (the 'compliance gaps') to identify any systemic non-compliance issues; and the consequential potential adverse impact on the reliability of financial statements.**

91. **Companies with securities admitted to trading on a regulated market are required, by the EU's IAS Regulation, to prepare financial statements using IFRS.** Under the provisions of the June 7th 2007 law amending the Accounting Law No., X-1178, Law Amending the Law on Financial Statements of Entities No. X-1179 and Law Amending the Law on Consolidated Accounts of Entities No., X-1180 limited civil liability profit-seeking legal persons whose securities are not traded on regulated markets shall be allowed to handle accounting and to prepare financial statements (consolidated accounts) in compliance with Business Accounting Standards or International Accounting Standards²². An analysis of the compliance with IFRS of a sample of IFRS prepared financial statements is given below.

The accounting standards gap

92. **Business Accounting Standards are prepared and adopted by the Accounting Institute and are based on IFRS with some key differences as noted below:**

- Under IFRS goodwill must be capitalized and tested for impairment on an annual basis. Under BAS goodwill must be capitalized and amortized.
- IFRS does not allow extraordinary items to be included in the income statement. BAS permits the use of such items; however, current recommendations are that companies should not have any.
- BAS does not require a statement of recognized income and expense.
- IFRS does not permit LIFO as the basis for inventory valuation. BAS permits LIFO, but only in very rare cases.
- Where an entity undertakes a sale and leaseback transaction where the sale is not at fair value, companies are not required to defer any element of the gain or loss and amortize over the period of expected use of the asset. Under IFRS certain elements of the gain or loss must be deferred and amortized.

²² For companies with fiscal years starting on July 1st, 2007 or later.

- BAS does not currently deal with revenue from services, although the ROSC team understands that this is an area under consideration.
- Functional currency is not defined in BAS as all transactions have to be registered in the presentational currency.
- Special purpose entities are not defined in BAS and there are no specific rules for them.
- Non current assets held for sale and discontinued activities are separately classified under IFRS and valued at the lower of its carrying amount and fair value less costs to sell. Under BAS there is no such separate classification and non-current tangible assets are held in inventory at residual value.

93. **The AIL should continue to develop Business Accounting Standards to be based on IFRS but adapted to be appropriate for the large majority of Lithuanian companies to which they apply.** The example of the recently issued draft IFRS Standard on ‘IFRS for Small and Medium-sized Entities (SMEs)’ should be taken in considering whether a BAS Standard on ‘BAS for SMEs’ is appropriate. Although many SMEs are allowed to prepare abridged financial statements in Lithuania, compliance with even these reduced financial reporting requirements is a significant challenge for these companies. External demand for their financial information is often limited to the filing requirement and as a basis for calculating taxation.

The compliance gap

94. **The ROSC assessed the compliance gap, sampling:**

- 17 sets of financial statements prepared in compliance with BAS were reviewed. These included seven audited financial statements of which two were insurance companies, and ten unaudited financial statements of which five were abridged financial statements²³.
- 14 sets of audited financial statements, which purport to be prepared in accordance with IFRS. These included nine sets of industrial company financial statements, four banking financial statements and one insurance company. All financial statements in the sample were audited by local member firms of international audit firm networks. Six audit reports were qualified.

BAS compliance

95. **Companies are required to submit annual financial information to the SECR and they also use their financial statements as the basis for their calculation of taxation.** There appears to be little use made of financial statements outside of the company, its management and owners. For example, few banks use financial statements as a basis for loan decisions; collateral-backed lending is prevalent. However, there is evidence of increasing demand for, and usage of, financial statements in lending decisions. Areas of non-compliance noted in the review of the sample of BAS financial statements include:

- Non-disclosure of related party transactions;
- Non-disclosure of the accounting policies adopted;
- Non-provision of deferred taxation;

²³ As banks do not prepare their financial statements in accordance with BAS, no bank financial statements were sampled and tested for their compliance with BAS.

- Poor presentation of links from primary statements to notes to the accounts
- Poor or missing explanation of abridged financial statements
- Non-disclosure of information relating to subsidiaries
- Incorrect presentation of comparative information relating to statement of changes in equity
- Poor compliance with BAS requirement for segmental reporting
- Impairment of accounts receivable and inventory not assessed or recorded
- Depreciation and amortization calculated according to tax rules and rates

96. **Some of the above areas of non-compliance relate to differences in the bases of key accounting items in general purpose financial statements prepared according to BAS and accounting items calculated as part of the calculation of corporate taxation.** As taxation is relatively effectively enforced, where the rules and standards for taxation purposes are different to those in BAS, many preparers will use the taxation rules. This leads to significant non-compliance in any area relating to accounting estimates (as taxation calculations do not generally allow estimates), valuation of assets and liabilities (taxation often requires a formulaic approach and the recognition of liabilities only if supported by paper-based evidence), and inaccurate use of accruals.

97. **A methodology which reconciles financial statements prepared according to BAS to the statements prepared for the calculation of corporate taxation, often called a ‘tax bridge’ is key if compliance with NAS is to improve.** Training in understanding this tax bridge is needed for preparers of financial statements (who are often ‘chief accountants’ at entities). Preparers need to understand the proper inter-relation of general purpose and taxation financial statements, while the taxation authorities also need to properly understand this inter-relation.

98. **Not all weaknesses in compliance related to taxation; the non-disclosure of cash flows, related party transactions and accounting policies noted above indicate a lack of knowledge and understanding of BAS generally among some preparers.** As noted in Section IIB, accountants who prepare financial statements across the range of entities need training and education in the application of BAS so they can meet the legislative requirement to apply BAS. However, this needs to be reinforced by effective enforcement of the requirement to use BAS. The current lack of such enforcement has resulted in widespread non-compliance, as reflected in the weaknesses noted above and the high proportion of qualified audit opinions issued. This also reflects the lack of demand and usage of entities’ financial statements, but such usage is unlikely to develop if the financial statements are not reliable or available.

IFRS compliance

99. **As noted above, IFRS financial statements are required to be prepared by companies with securities admitted to trading on a regulated market; going forward, all limited civil liability profit-seeking legal persons whose securities are not traded on regulated markets will have the option of preparing financial statements under IFRS²⁴.** IFRS statements are generally prepared with the assistance of an international accountancy firm and are often audited by the same firm (leading to potential conflicts of interest). The review of the IFRS financial statements of non-financial institutions indicated a reasonable quality, although a high percentage of the financial statements had a qualified audit report. Areas of noted non-compliance in the IFRS financial statements include:

²⁴ Companies in these categories with fiscal years beginning on July 1st, 2007 or later will have the option to use IFRS.

- Very broad categories in respect of property, plant and equipment such that the depreciation rates applied to one category vary between, say, 5 and 50 years. This suggests that the PPE should be broken down into more groups or classes of assets with similar useful lives providing the user with more helpful information;
- Limited or non-existent deferred tax disclosures;
- Weak revenue recognition policies which in certain cases do not comply with IAS 18; and
- Incorrect disclosure of subsidiaries held for sale which was not in compliance with IFRS 5.

100. **The quality of the four bank IFRS financial statements reviewed was of a high standard, showing only minor evidence of non-compliance.** All of the bank financial statements reviewed had an unqualified audit opinion. All areas of possible conflicts with IAS in the consolidated financial statements of individual banks in the ROSC report 2002 appeared to no longer be an issue in this review.

101. **At present, the operational activities of companies in Lithuania are relatively simple; as a result, the most complex areas dealt with by IFRS, such as accounting for defined benefit pension scheme, special purpose entities, share based payments or financial instruments, are largely irrelevant.** However, this report notes that, as the economy develops, the operations, funding strategies and remuneration packages in Lithuanian companies are likely to move into these more complex areas; this will create significant challenges for preparers and auditors of financial statements.

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

The auditing standards gap

102. **The Law on Audit requires the use of Lithuanian National Standards on Auditing (NSA) as promulgated by the LCA, or International Standards on Auditing (ISA) as promulgated by the IAASB for all Lithuanian auditors and audit firms.**

103. **The detailed review of NSA's compliance with ISA identified the following major differences:**

- Part of ISA 250 requires the auditor to consider if they are required to report non-compliance with regulations to regulatory authorities such as financial or securities regulators. There appears to be no such requirement in NSA, or such a reporting requirement to regulators. This may weaken the auditor's position in having their findings considered by the client, as well as weakening enforcement by the regulators.
- ISA 220 on the role of the engagement partner in exercising quality control for audits does not appear to be replicated in NSA. This means that an important internal quality control measure for auditors may be absent.
- Finally, as mentioned above, ISA 200 requires compliance with the IFAC Code of Ethics. The NSA requires compliance with the LCA's Auditors Code of Ethics, which is based on IFAC's Code of Ethics from 2000. The LCA's Code of Ethics should be updated to reflect recent developments in IFAC's Code of Ethics.

104. **As detailed in Section IID above, ISA are only translated periodically (the first and most recent translation was in 2005) into Lithuanian and thus there is a standards gap**

resulting from the time-lag in translation in practice as few auditors outside of members of international audit firms or networks are able to amend their audit methodology to take account of changes to ISA and supporting standards, such as ISQC1 (a quality control standard for auditors) and the ethics code, as they are issued in English. However, the practical effects of this are slight when compared to the potential effects of the compliance gap noted below for many auditors.

The auditing standards compliance gap

105. **The audit reports in the sample of 17 BAS and 11 IFRS financial statements were reviewed and interviews were held with auditors from a variety of small and large audit firms in Lithuania.** The audit reports for the BAS financial statements were not generally compliant with the format required under NSA for an audit opinion; common differences included reports addressing the company management, reports covering a wider scope of issues than the auditor's opinion on the financial statements, and inaccurate wording.

106. **The auditors' reports on the financial statements prepared in accordance with IFRS appeared to be generally compliant with ISA.** However, from discussions with the accounting personnel of some of the entities reviewed it appeared that some of the IFRS financial statements may largely be prepared by the auditors themselves. Preparing and then auditing financial statements is not compliant with ISA, and raises issues of independence which may conflict with the ethical code for auditors.

107. **From the discussions with auditors from a variety of audit firms in Lithuania it is clear that the level of compliance with NSA or ISA is determined by the quality of the audit methodology used by audit firms.** Application of the both NSA and ISA standards requires an auditor to make an assessment of risk and internal controls, leading to an audit strategy and plan that encompass systems, transactions and balance testing which will enable the auditor to gain sufficient and appropriate audit evidence to enable him to express an opinion on the financial statements. The LCA has developed and published guidance and methodologies for its members; one common outcome of quality control inspection visits is to require the auditor to use the LCA's methodology in areas of weakness found. However, the methodology does not address in detail the tailoring of an audit that is required for specialized sectors of economy, such as auditing listed entities, banks and NBFIs, for which very little guidance and expertise is available. Audit firms which undertake such audits are therefore high risk and should of particular concern to the quality assurance (see Section IIE above).

108. **Use of any specific audit methodology, need not be made compulsory for all auditors or audit firms – some firms such as international network firms have well developed audit methodologies of their own.** However, many smaller firms or individual auditors do not have a well-developed NSA or ISA compliant audit methodology. Where an audit quality inspection finds deficiencies in an auditor's practices, determined methodology or aspects of it could be a condition of continued registration. Requiring targeted training (or re-training) on the use of a suitable audit methodology is another option to impose as a condition to remedy weaknesses noted in inspections.

109. **One other indicator of the compliance of auditors with auditing standards is the very high level of qualified audit opinions issued (38% of all opinions were qualified in 2005, per the LCA).** While this indicates an unwillingness of companies to take auditor's findings into account and to make necessary amendments for the auditors to issue unqualified opinions, it is also indicative that auditors are performing sufficient audit work to generate audit findings leading to a qualification. The high level of qualifications also indicates a problem with compliance with accounting standards (see Section III above). The main reason for this appears to be a simple unwillingness of company management to comply with applicable standards, even

when non-compliance is clearly demonstrated to them (and the public) by the qualified audit opinion. This is indicative of the lack of effective enforcement measures for corporate financial reporting in Lithuania at present.

V. PERCEPTION OF THE QUALITY OF FINANCIAL REPORTING

110. **There is a general perception that statutory financial statements of non-listed companies are of low quality and there appears to be little genuine external demand for financial information of Lithuanian companies.** Where there is a genuine external need for such information, for instance by a lender, contractual agreements are put in place to require the company to pass the relevant information to the lender. There appears to be little or no reliance on publicly filed information other than for the purposes of taxation and statistics. However, it is unlikely that more reliance or use will be made of financial information until it can be perceived as more reliable and accurate, so some enforcement of the quality of entities' financial information would appear to be required.

111. **There is a perception that the quality of financial statements of banks and insurance companies were of a higher quality, especially many are foreign owned.** This perception is also related to the perceived effective regulation by the Bank of Lithuania and ISC. In relation to listed companies, there are some companies whose financial statements are perceived to be of high quality, containing valuable, useful and relevant information; these tend to be the companies with a high adherence to the code on corporate governance and who have institutional and overseas shareholders. There are also some listed companies whose financial statements are perceived to be of low quality and little reliance is placed on this information; if these companies wish to attract institutional and overseas shareholders, it is likely that the transparency of financial information produced will have to improve.

112. **Auditors' reports, and the work and role of auditors preparing them, appear to have limited perceived value; this is clear from the large proportion of such audit reports that have a qualified auditor opinion.** Many times this is due to management disagreements with auditors regarding the level of compliance of their financial statements with Lithuanian BAS or IFRS and management's refusal to make recommended changes. This reflects a lack of enforcement of compliance with accounting standards by both the market and by authorities.

113. **There is a perception that the quality of audit varies greatly across the range of auditors and audit firms in Lithuania.** While the local network firms of the four largest international audit firms and local member firms of international networks have the benefit of firm-wide internal quality control procedures, many local firms have to solely rely on their own, limited resources and experience. As a result, there is a perception that only a very few local audit firms are capable of performing fully ISA-compliant audits and that, outside these few firms, audit quality is very low, even to the extent that no effective assurance is given. The very low price paid for some audits may confirm this perception. Large differences in the technical proficiency, level of experience and level of resources across audit firms may contribute to the perceived variations in audit quality.

VI. POLICY RECOMMENDATIONS

114. **The principal objective of this ROSC assessment is to assist the authorities and other stakeholders in strengthening the financial and non-financial sectors' accounting, financial reporting and auditing practices, as a means to support certain relevant strategic objectives for Lithuania, including:**

- Enhancing the business climate and bolstering domestic and foreign direct and portfolio investment in the private sector;
- Strengthening the stability and competitiveness of the banking and non-banking financial sectors; and mitigating the risk of crises due to loan collection problems and weak capital base;
- Encouraging greater transparency in both State and privately-owned enterprises, thus allowing shareholders and the public at large to assess management performance and influence its behavior;
- Aligning the normative and legal framework in the area of financial reporting, accounting and auditing with the best international practices;
- Facilitating SME access to credit by encouraging a shift from collateral-based lending decisions to lending decisions based on the financial performance of the prospective borrower, thereby supporting growth in the SME sector; and
- Helping to ensure that the financial reporting and auditing rules applicable to different types and sizes of entity are appropriate to the needs of those entities and the users of their financial statements.

Without attempting to provide a detailed tactical design for reforms, this report sketches the policy recommendations to support the implementation of accounting reform and ultimately enhance the quality of corporate financial reporting.

115. **The recommendations of this ROSC are interrelated and mutually supportive, designed to collectively improve the financial reporting environment in Lithuania.** For example, good accounting standards are jeopardized if practitioners do not understand how to translate them into journal entries; a rigorous statutory and regulatory framework is unlikely to be effective if it is not enforced.

116. **The policy recommendations outlined in this report are based on the assumption that long-term country objectives include thorough modernization of the accounting and auditing professions, and development of a business environment conducive to preparation of transparent financial information compliant with international standards.** As set forth in this report, achievement of these objectives requires continuous reorganization and improvement of Lithuania's legal framework, institutions, accounting and auditing professions, as well as change in its business culture and education system. However, policies should not be developed and enacted without giving due regard to a country's ability to carry out such policies (both in terms of capacity and resources); a relatively lenient rule that is robustly and consistently enforced is preferable to a good, rigorous one that is unenforceable, as the lenient rule can be progressively made more rigorous as the circumstances allow. The policy recommendations below, while challenging, can be carried out in the short- to medium-term and are conducive to Lithuania's long-term objectives. They fall into four key areas:

- Statutory and legal framework
- Measures to improve enforcement of legal requirements for corporate financial reporting
- Institutional and capacity building measures; and
- Professional education and training.

117. **These recommendations require a holistic approach to implementation. Lithuania should establish a multidisciplinary National Steering Committee (NSC) to champion and coordinate the accounting and auditing reforms.** This NSC is expected to include representatives from the Ministry of Finance of the Republic of Lithuania, the Ministry of Justice, the Ministry of Economics, the Bank of Lithuania (BoL), the Accounting Institute, the Lithuanian Chamber of Auditors (LCA), the major universities and colleges in Lithuania, the Vilnius Stock Exchange (VSE), the Lithuanian Securities Commission (LSC), the Department of Statistics, the SECR, the Insurance Supervisory Commission (ISC) and representatives from other stakeholder organizations. The NSC should advise policymakers and regulators regarding the implementation of the recommendations. Based on the successful experience of other countries, this report recommends that the NSC develop a Country Strategy and a detailed Country Action Plan (CAP) which clearly sets out the key actions and allocates responsibilities for implementing the necessary reforms; the CAP should include a itemized budget indicating the resources necessary for successful implementation and the government, policymakers and development partners should work together to secure those resources so as to achieve the common goal of enhancing the quality and availability of financial information in Lithuania.

A. Statutory and Legal Framework

118. **In the past few years, the Lithuanian legal framework has been significantly updated.** This is due in large part to Lithuania's accession to the European Union and the need to transpose EU directives and laws into Lithuanian law. Changes have included modifications to the Law on Accounting, the Law on Financial Institutions, and most recently, further proposed modifications to the Audit Law. The reform to date is commendable; however, some further reform is needed in some key areas if the statutory framework for accounting and auditing is to conform to international best practice and be comparable to similar frameworks across Europe. Accordingly, this report recommends that the Ministry of Finance of Lithuania takes the lead in working with the Parliament (Seimas), key regulatory institutions and other stakeholders to amend the Laws and regulations as appropriate.

119. **This report recommends that the statutory and legal framework for corporate financial reporting be amended to:**

- Implement the requirements of the amended EU Eighth Company Law Directive in a manner appropriate to the needs of the Lithuanian economy. The example of peer countries should be considered when devising the nature of the public oversight of the audit profession that will be implemented and, in particular, when considering the division of activities between the public oversight body and the existing professional body for audit. The capacity and other important roles of the body proposed to be the new public oversight body (currently the Accounting Institute) should also be taken into account.
- Make financial reporting requirements for Small and Medium-sized Entities (SMEs) appropriate for the needs of the market and such entities. The example of the recently issued draft IFRS Standard on 'IFRS for SMEs' should be taken in considering whether a BAS Standard on 'BAS for SMEs' is appropriate. BAS are based on IFRS and, similarly to IFRS, current BAS may not be appropriate for the needs of some SMEs.
- Extend the period allowed for non-listed companies to prepare and approve their financial statements from the current four months.

B. Improving Enforcement of Requirements for Corporate Financial Reporting

120. Measures should be taken to improve the enforcement of companies' compliance with the legal requirements for corporate financial reporting. These measures should include:

- Increasing the levels of fines for late filing, lack of filing and inappropriate filing of financial information to enhance the enforcement environment for corporate financial reporting in Lithuania. Fines should be increased and should be determined on a rolling and not fixed basis. The more time that elapses between the legal deadline for filing and the date financial statements are actually filed, the larger the fine should become.
- Require that the database holding company financial information maintained by the SECR be used to keep information on the types of audit opinions expressed and the audit firms performing each audit. Doing this will publicly highlight companies which do not, in their own auditor's opinion, comply with financial reporting standards in preparing their financial information, as is required by law.
- Require statutory auditors to monitor the company's compliance with filing requirements for the proceeding year during the annual audit. Information regarding whether or not a company is in compliance with this requirement could be included in the auditor's long form report. This will act as another form of enforcement of the legal requirements on companies to file financial information. Including the LCA in the development of this new auditor task may help in training auditors on the details of this task.
- The Securities Commission establishing risk-based monitoring of financial statement compliance and considering delegating the detailed review of IFRS financial statements to another competent body.
- Developing the capacity to investigate complaints or problem cases of financial reporting. Such complaints could be referred by either the public or by other regulators such as the SECR or LCA (e.g. where a company's audit opinion is consistently qualified).

The ROSC team is happy to discuss in more detail with all stakeholders how such enforcement may be practically and proportionately achieved.

C. Institutional and Capacity Building Measures

121. All the regulators and institutions with responsibilities for aspects of the financial reporting process, including the MoF, BoL, LSC, ISC, SECR, AIL and LCA, face increasing challenges as the demand for high quality financial reporting grows and requirements for accounting and auditing become more sophisticated. There is a consistent need for institutional and capacity building measures at each institution - the developing roles of the SECR, LSC and the Lithuanian Accounting Institute in particular will necessitate extra resources if they are to be fulfilled effectively. Accordingly, this report recommends that:

- Each institution develop a long-term business plan, setting out the revenues and resources required to carry out its responsibilities and options for ways to fulfill these needs. The plans are likely to require the implementation of a coordinated capacity-building program, including staff internships in leading international professional associations and regulators, as well as the recruitment of personnel with appropriate accounting and auditing qualifications and experience. Sharing experiences with regional counterparts in peer countries to develop common solutions to common challenges could be a helpful first step.

- The Lithuanian Association of Accountants and Auditors continue its efforts to seek to increase its membership to establish and represent an organized accounting profession in Lithuania. It should be supported where possible in this effort by the Ministry of Finance (while not necessarily establishing any legal requirement for membership), regulators, the AIL, employers organizations and other professional organizations such as the LCA. A strong professional organization of accountants, such as exists in Poland, can act as the focal point and conduit for improving the quality of preparers of financial information.
- The Lithuanian Chamber of Auditors, subject to any revision of its role in the new Audit Law, should:
 - Recognize a wider range of training courses and course providers as appropriate for fulfilling auditors' CPD requirements, assuming the courses are of appropriate standard.
 - Work proactively with the new public oversight body for audit to openly cooperate in both organization's shared goal of improving audit quality in Lithuania

D. Professional Education and Training

122. **In parallel to improving the statutory framework and its enforcement, there is a strong need to improve the capacity of the accounting and auditing professions.** The genuine understanding and adoption of national and international accounting, financial reporting and auditing standards and requirements requires relevant education and training for financial statement preparers, auditors, and regulators. In this regard, it is essential to enhance the capacity of existing accountants as well as ensure the capacity of future accountants. Measures should include:

- A major program to 're-train the trainers'. It is essential that the knowledge of professors of accounting and auditing at the university and college level be kept up-to-date, as many times they provide the only training or education accountants obtain before entering the workplace. Senior professors of accounting in Lithuania highlighted that the challenge of keeping accounting expertise current is one shared across the region. Therefore a program of re-tooling teachers of accounting and auditing in all three Baltic States and possibly other neighboring countries such as Poland may be useful. In addition, international seminars and exchange programs between Lithuanian university professors and professors from Sweden and other EU member countries should be pursued.
- The Ministry of Education addressing tertiary level accounting and auditing education in its program of reform of tertiary education. Possible reforms should include more experienced-based learning (i.e. audit/financial statement preparation simulations, internships, group projects, etc.) and utilizing employers and professional organizations to help construct syllabi which reflect the needs of the workplace. This would help address the widely-reported 'gap' between the skills graduates currently have on graduation and those required by employers. Other initiatives could include assisting the Lithuanian Association of Educators and Researchers of Accounting (LAERA) in raising and standardizing the quality of accounting education nation-wide
- Encouraging the development of the accountancy profession by coordinating tertiary education with elements of professional examinations. The professional organizations should work with the LAERA to coordinate of syllabi and subjects taught so as to offer exemptions from parts of the professional examinations to

students who have majored in accountancy. Such exemptions reduce the time and cost of the professional qualifications, and thus increase training capacity. It also enhances the attractiveness to graduates of joining the profession and the professional organization.

- Finally, steps should be taken to allow individuals who hold internationally-recognized qualifications, such as the ACCA or the US CPA, to be able to obtain recognition by the LCA as professional certified auditors. This may include allowing exemptions for most of the LCA's audit examination and requiring that these individuals pass the examination sections on Lithuanian taxation and relevant law.