

# REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC) Bulgaria

## ACCOUNTING AND AUDITING

December 2008

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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 Bulgaria. The report uses International Financial Reporting Standards (IFRS), International Standards on Auditing (ISA), and the relevant portions of European Union (EU) law (also known as the *acquis communautaire*) 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. This assessment is an update of the previous Accounting and Auditing Report on the Observance of Standards and Codes (A&A ROSC)<sup>1</sup> conducted in Bulgaria in 2002 (see Table 1 for the progress on key recommendations of the 2002 A&A ROSC).

Since the 2002 A&A ROSC, there have been several changes in the accounting and auditing regulatory framework of Bulgaria. Enterprises that issue securities to the public, banks and other credit institutions, insurance and investment companies, companies for additional social security and the funds managed by them, are now required to prepare financial statements in accordance with International Financial Reporting Standards as adopted by the European Commission (*endorsed* IFRS). Other entities, depending on their size, are required to use either *endorsed* IFRS or the Bulgarian National Financial Reporting Standards for Small and Medium-Sized Enterprises (NFRSSME). Governmental organizations continue to use Bulgarian National Accounting Standards for the Public Sector. These standards are based on the International Public Sector Accounting Standards issued by the International Public Sector Accounting Standards Board.

All enterprises that issue securities to the public, credit institutions (including banks), insurance and investment companies, companies for additional social security and the funds managed by them, are statutorily required to have their financial statements audited. The audit must be performed by registered auditors in accordance with ISA. Other entities that meet certain size

<sup>1</sup> The 2002 A&A ROSC is available at [www.worldbank.org/ifa/rosc\\_bgr.pdf](http://www.worldbank.org/ifa/rosc_bgr.pdf)

criteria are also required to have their financial statements audited.

Since Bulgaria's accession to the EU in 2007, legislation has been substantially amended to comply with the EU First, Second, Fourth, Seventh, and Eighth Company Law Directives, as well as the Transparency Directive, the IAS Regulation, and the Banks and Insurance Accounts Directives. In 2008, Bulgaria drafted amendments and supplements to the Independent Financial Auditing Act (Audit Act) and the Accountancy Act to ensure compliance with recent changes to the Eighth Company Law Directive. The Audit Act amendments were promulgated on July 29<sup>th</sup>, 2008 and the Accountancy Act amendments were promulgated on August 5<sup>th</sup> 2008.

Bulgaria has made great progress in improving its accounting and auditing regulatory framework. However, while some of the 2002 A&A ROSC policy recommendations have been resolved by changes in practices and amendments to the Audit Act and the Accountancy Act, a number of recommendations have not been implemented, or have been only partially implemented. The proper implementation of the Eighth EU Company Law Directive and the Transparency Directive, and the creation of a multi-disciplinary working group to review the present report's recommendations (see Table 2) and to address future concerns would help in many of these areas.

The accounting profession is fragmented. There are four different professional associations in the country with the result being low institutional capacity. Furthermore, there is no quality assurance, investigation and discipline process on the work of accountants and financial statement preparers. The auditing profession is better organized with one association mandated by law to manage access to the profession, training, the code of ethics and quality control. However, the association's membership is stagnant and the training of members, control of the quality of their work, public oversight, and the code of ethics need to be improved.

The accounting standards gap analysis done as part of this review revealed that NFRSSME need to be kept up to date in light of revisions to *endorsed* IFRS and development of standards more suitable for application by SMEs. Further, the accounting and auditing compliance gap analysis concluded that financial statements are severely non-compliant with both *endorsed* IFRS and NFRSSME. Deficiencies were also noted in regards to auditing practices. Improved education, training, quality control, enforcement, and public oversight are essential for the future success of accounting and auditing.

Professional education and training on international standards of accounting and auditing requires much improvement for students, accountants, auditors and tax inspectors. This improvement is needed at each of the universities, the professional bodies and the government.

Thus, we believe priorities should now be given to building the monitoring, supervisory, and disciplinary regimes necessary to ensure effective compliance. This assessment demonstrates that the effective enforcement of accounting, auditing, and ethical standards is the next challenge that Bulgaria has to address.

While the report highlights a major program of required reforms to ensure practices catch up with recent regulatory enhancements, we commend Bulgaria for its achievements to date, some of which go beyond what is presently required by the *acquis communautaire* and what has been adopted by peer EU Member States.

This report was prepared on the basis of the findings from a diagnostic review carried out in Bulgaria by a team from the World Bank in June 2008. The team was led by Luc Cardinal and comprised David Nagy, Jan Tyl, and consultants. The review was conducted through a participatory process involving various stakeholders and led by the country authorities.

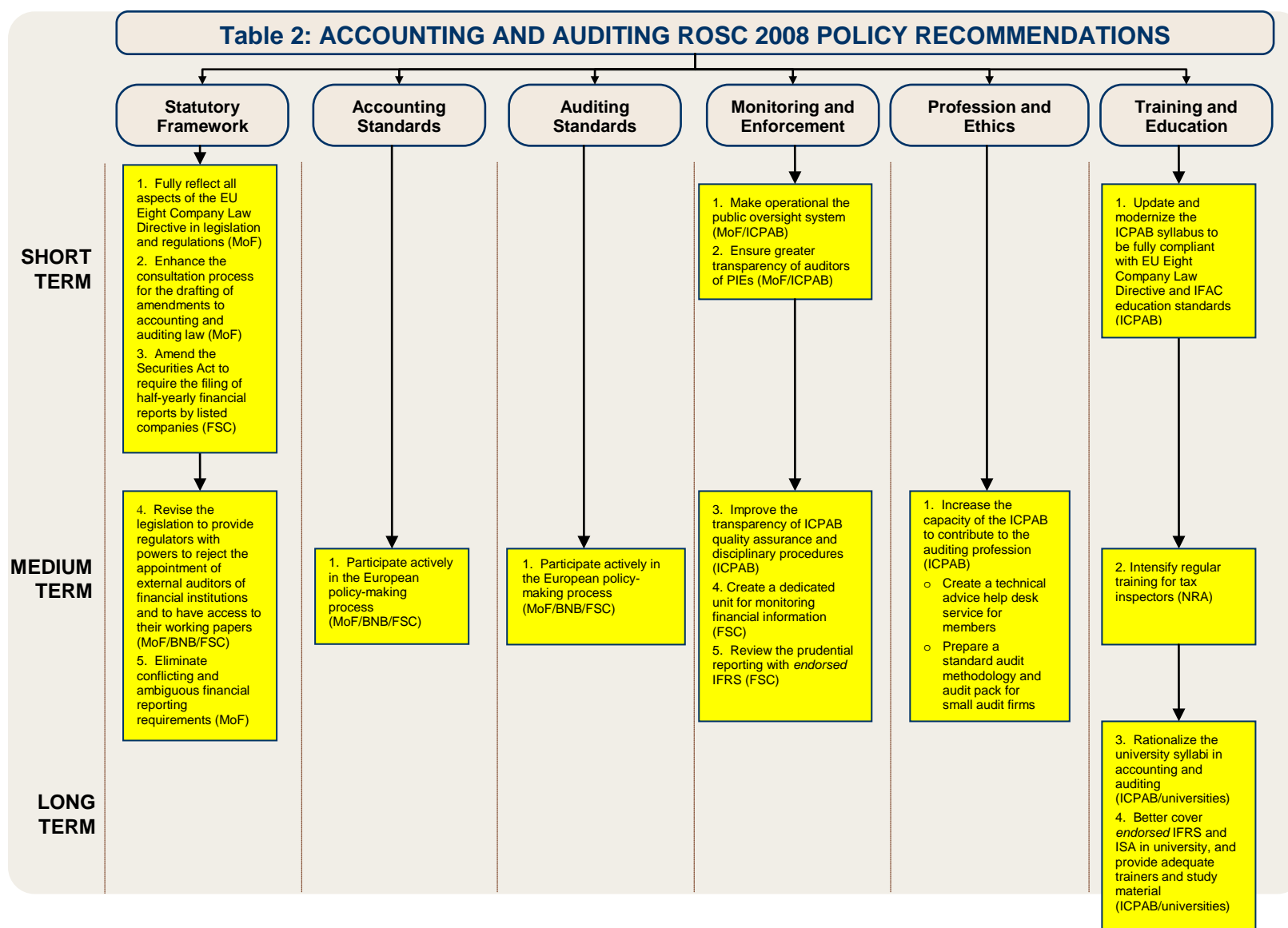
**Table 1: Progress on key recommendations of the previous A&A ROSC 2002**

<b>Key A&amp;A ROSC 2002 Recommendations</b> <b>Status as of June 2008</b>		
<b>Amend accounting and auditing laws and standards.</b>		
1	Remove existing discrepancies and avoid future inconsistencies with IFRS in the Accountancy Act.	Implemented
2	Provide small and medium-sized enterprises (SMEs) with a reporting framework more adapted to their size than IFRS in the Accountancy Act.	Implemented.
3	Take maximum advantage of the accounting and auditing exemption in the Fourth EU Company Law Directive for SMEs when there is no public interest requirement for the preparation, publication, or audit of financial statements.	Partially implemented
4	Strengthen the capacity of the appropriate body to enable (a) immediate translation and adoption of new International Financial Reporting Standards and exposure drafts issued by the International Accounting Standards Board, and new interpretations developed by the International Financial Reporting Interpretations Committee (IFRIC); and (b) to issue implementation guidelines on the individual IFRS that should link into IFRIC.	a) Translation and implementation guidelines are now done by the European Commission
<b>Financial reporting and auditing of banks, insurance companies, and pension funds (collectively referred to as financial institutions).</b>		
5	The supervisory institutions and/or the related laws should strive to provide financial information, as needed. Where the BNB and other regulators need additional (unpublished) information for prudential supervision purposes, this should be by way of topping-up IFRS.	Implemented
<b>Enforce publication and filing of legal entity and consolidated financial statements. The Accountancy Act should be amended and enforcement mechanisms reviewed as follows:</b>		
6	The Accountancy Act should conform the date of publication of legal entity and consolidated financial statements.	Implemented
7	The requirement of the Accountancy Act that “financial statements should be published in the form in which they were audited and with the auditor’s report” should be strictly enforced.	Not implemented
8	The publication of erroneous and misleading annual reports should be subject to severe penalties, which may include administrative penalties, civil liability, and—in the event of fraud—criminal liability.	Partially implemented
<b>Strengthen oversight of accounting and auditing regulations.</b>		
10	The BNB, the FSC and other regulators should review IFRS financial statements of all listed companies and take appropriate action against those companies and their auditors when the financial statements do not comply fully with IFRS.	Partially implemented
11	The ICPAB should implement a quality assurance system to ensure that auditors comply with applicable auditing and ethical standards, and independence requirements.	While a system has been implemented, its operating effectiveness needs to be assessed.
12	An appropriate body should be established to exercise oversight of the determination of the audit rules issued by the audit profession, the application of accounting and auditing regulations, and the discipline of auditors.	Implementation in progress.
13	The aforementioned oversight body should, among other duties, take over the authority granted by the Audit Act to the chairman of the Managing Board of the ICPAB to impose sanctions for auditor’s misconduct and violations.	Implementation in progress

**Table 1: Progress on Key Recommendations of the Previous A&A ROSC 2002 (cont'd)**

<b>Key A&amp;A ROSC 2002 Recommendations</b>		<b>Status as of June 2008</b>
<b>Amend accounting and auditing laws and standards. The strategic training plans should encompass some of the following areas:</b>		
14	Develop an accounting curriculum at colleges and universities that meets the needs of corporate Bulgaria.	Partially implemented
15	Assist corporate Bulgaria in assessing their training requirements arising from the introduction of IFRS and conduct training that extends beyond the accounting department.	Partially implemented
16	Provide meaningful IFRS theoretical and practical training to the Financial Supervision Commission so they can enforce accounting standards.	Partially implemented
17	Provide IFRS training to corporate income tax inspectors	Partially implemented
18	Organize additional IFRS and ISA training, including practical training and coaching, for grandfathered auditors where recommended by the ICPAB quality assurance review.	Implemented
19	Review the professional education, examination, and traineeship arrangements to ensure that they are in line with internationally recognized accreditations.	Partially implemented

**Table 2: ACCOUNTING AND AUDITING ROSC 2008 POLICY RECOMMENDATIONS**



## MAIN ABBREVIATIONS AND ACRONYMS

ACCA	Association of Chartered Certified Accountants (United Kingdom)
Audit Act	Independent Financial Audit Act
A&A ROSC	Accounting and Auditing Report on the Observance of Standards and Codes
Banks Accounts Directive	EU Directive on the Annual Accounts and Consolidated Accounts of Banks and Other Financial Institutions (86/635/EEC)
BGN	Bulgarian Lev (pegged to the EUR at 1.95583)
BNB	Bulgarian National Bank
BTC	Bulgarian Telecommunication Company
CEBS	Committee of European Banking Supervisors
CESR	Committee of European Securities Regulators
CPD	Continuing Professional Development
EU	European Union
FSC	Financial Supervision Commission
Endorsed IFRS	International Financial Reporting Standards adopted by the European Commission
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IASB	International Accounting Standards Board
IAS	International Accounting Standards (now IFRS)
IAS Regulation	EU Regulation (EC) 1606/2002 on the Application of International Accounting Standards
ICPAB	Institute of Certified Public Accountants of Bulgaria
IFAC	International Federation of Accountants
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
Insurance Accounts Directive	EU Directive on the Annual Accounts and Consolidated Accounts of Insurance Undertakings (91/674/EEC)
IPO	Initial Public Offering
ISA	International Standards on Auditing
LIFO	Last in first out
MoF	Ministry of Finance
NFRSSME	National Financial Reporting Standards for Small and Medium-Sized Enterprises
NRA	National Revenue Agency
PIE	Public Interest Entity
Securities Act	Markets in Financial Instrument Act
SME	Small and Medium-Sized Enterprise

## I. INTRODUCTION

1. This assessment of accounting and auditing practices (A&A ROSC) in Bulgaria is part of a joint initiative by the World Bank and the International Monetary Fund to prepare Reports on the Observance of Standards and Codes<sup>2</sup>. The assessment focuses on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting, and includes a review of both statutory requirements and actual practice. It uses International Financial Reporting Standards (IFRS)<sup>3</sup> and International Standards on Auditing (ISA)<sup>4</sup> as benchmarks and draws on international experience and best practices. This assessment is an update of the previous A&A ROSC conducted in Bulgaria in 2002.

2. The report has regard to the *acquis communautaire*, which is relevant to Bulgaria for two reasons. First, it represents a high-quality model for the regulation of accounting and auditing that can be applied by countries of differing characteristics. Second, the adoption of the *acquis communautaire* is required as a result of the recent accession of Bulgaria to the European Union (EU). The EU requires the use of only those IFRS which have specifically been determined to be suitable for use in the EU, and has established an endorsement process to determine whether each IASB standard and interpretation will be approved (endorsed). This report uses the term *endorsed* IFRS to refer to those IFRS that have been approved by the EU. In particular, this report benchmarks the Bulgarian regulatory framework and institutional capacity against the First, Second, Fourth, Seventh, and Eighth Company Law Directives, as well as the Transparency Directive, the Regulation on the Application of International Accounting Standards (IAS Regulation), and the Directive on the Annual Accounts and Consolidated Accounts of Banks and Other Financial Institutions (Banks Accounts Directive) and the Directive on the Annual Accounts and Consolidated Accounts of Insurance Undertakings (Insurance Accounts Directive).

3. Bulgaria has a population of about 7.7 million people with approximately 1.4 million of those people living in Bulgaria's capital city, Sofia<sup>5</sup>. Since 1990, Bulgaria had a successful transition toward political democracy and moving to a market economy, while fighting inflation and unemployment. Bulgaria is a unitary multiparty republic with one legislative body (National Assembly) and had a gross national income per capita<sup>6</sup> of EUR 1,850 in 2006. Bulgaria had more than 250,000 commercial entities in 2006 (Table 3).

**Table 3: Commercial entities (non-financial) in 2006**

Type	Number	Contribution to GDP
Limited liability companies	93,146	51.2
Joint-stock companies	5,923	38.6
Unlimited partnerships	3,409	0.6
Limited partnerships	45	0.1
Other (sole traders, cooperatives, civil entities, etc...)	155,427	9.5
Total	257,950	100.0

Source: Bulgarian Ministry of Finance

<sup>2</sup> For more information, please see [www.worldbank.org/ifa/rosc\\_aa.html](http://www.worldbank.org/ifa/rosc_aa.html)

<sup>3</sup> International Financial Reporting Standards are issued by the International Accounting Standards Board (IASB), an independent accounting standard-setter based in London, United Kingdom. The IASB announced in April 2001 that its accounting standards would be designated "International Financial Reporting Standards" (IFRS). Also in April 2001, the IASB announced that it would adopt all of the International Accounting Standards (IAS) issued by the International Accounting Standards Committee (IASC). Within this report, the term IFRS encompasses both IFRS and IAS, as well as the related interpretations.

<sup>4</sup> International Standards on Auditing (ISA) are the standards issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants (IFAC).

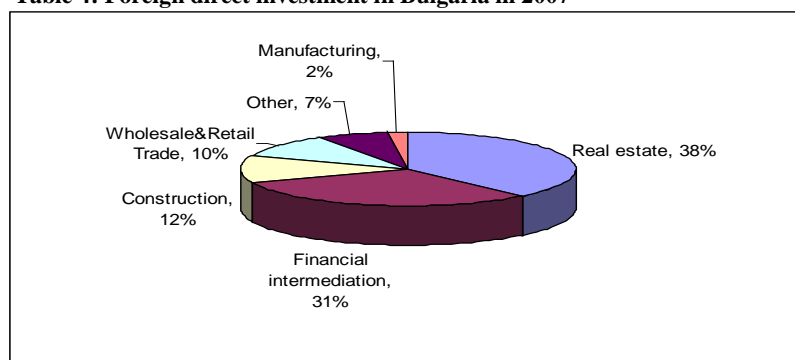
<sup>5</sup> National Statistical Institute of Bulgaria

<sup>6</sup> Per the Atlas Method.

4. Bulgaria's gross domestic product (GDP) has been growing steadily at a rate of 5% to 6% per year between 2000 and 2007<sup>7</sup>. The steady growth seen in the economy has been attributed to macroeconomic stability achieved through the currency board that was introduced in 1997. Fuelling this growth has been domestic demand with investment contribution outpacing private consumption growth since 2004. Furthermore, since 2002, the Bulgarian government has made serious efforts and progress in privatizing state owned enterprises.

5. Bulgaria has a liberal foreign investment regime and attracting foreign investment is one of the government's top priorities. Since 2004, annual foreign direct investment inflows (FDI) have exceeded 14% of GDP and in 2007 amounted to approximately EUR 4 billion<sup>8</sup>.

**Table 4: Foreign direct investment in Bulgaria in 2007**



Source: BNB

As demonstrated in the above chart (Table 4), a large proportion of the FDI inflows has been in non-manufacturing sectors, like real estate and construction (50% of total FDI in 2007), while manufacturing took only 2% of total FDI.<sup>9</sup>

6. Since the Bulgarian National Bank (BNB) introduced stronger banking supervision and tighter prudential rules, financial discipline has improved in the banking sector. The reinforced supervision and tighter prudential rules are part of the program of reforms linked to the introduction of the currency board with strict requirements for "large credits" and a phased increase of capital-adequacy requirements. The required minimum capital adequacy ratio of 12% far exceeds the international recommended standard of 8%. Although capital-adequacy ratios of banks have fallen, they still stood at 13.9% at the end of September 2007. In addition, the percentage of non-performing loans to the total loans held by banks has dropped from more than 10% in 2000 to 2.2% in September 2007, while domestic credit provided by the banking sector (as a % of GDP) has more than tripled from 18% in 2000 to about 60% in 2007. A bank privatization program was put in place and completed with foreign investors playing an important role (Table 5) by helping to recapitalize the system and providing a much needed infusion of banking expertise.<sup>10</sup>

<sup>7</sup> World Bank data.

<sup>8</sup> Bulgarian National Bank data.

<sup>9</sup> Bulgarian National Bank data.

<sup>10</sup> Bulgarian National Bank data



**Table 5: Bulgarian banks as at December 31<sup>st</sup>, 2007**

Type	Number	Assets (BGN'000)	Assets (EUR'000)	% of assets
With Bulgarian participation	8	10,457,626	5,346,899	17.7
Branches of foreign banks	2	483,366	247,141	0.8
With foreign participation	3	1,213,518	620,462	2.1
Branches of EU Member State banks	3	2,419,332	1,236,985	4.1
With EU Member State participation	13	44,520,136	22,762,784	75.3
Total	29	59,093,978	30,214,271	100.0

Source: Bulgarian National Bank

7. In comparison to the banking sector, the insurance market is still relatively underdeveloped, but growing quickly. Total gross insurance premiums of BGN 1.5 billion (EUR 728 million) as at December 31<sup>st</sup> 2007 (Table 6) showed year over years increases of 20% in 2007, 17% in 2006, 28% in 2005 and 15 % in 2004.

**Table 6: Bulgarian insurance companies**

Type	Number	2007 gross premiums (BGN million)	2007 gross premiums (EUR million)
Non-life	20	1,072	548
Life	17	430	220
Total	37	1502	768

Source: Financial Supervision Commission

Even with these increases in gross premiums, the insurance penetration indicator (gross premium income to GDP) is only 2.65% and the gross premium income per capita is BGN 196 (EUR 100). Motor vehicle insurance continues to dominate with two-thirds of the total gross premiums, although other non-life segments and life insurance are posting gains every year. Prior to legal reforms in 1997, foreign involvement in the insurance market was severely limited. Currently however, there are several foreign owned insurance companies. Bulstrad and DZI, two of the largest insurance companies which were previously state owned, are now majority foreign owned. As at December 31<sup>st</sup> 2007, foreign shareholders owned 27 of the 37 insurance companies. These 27 companies represented 50% of the total capital of insurance companies. One insurance company continues to be owned by the government of Bulgaria<sup>11</sup>.

8. The Bulgarian stock market had as at December 31<sup>st</sup> 2007, 530 listed companies<sup>12</sup> with a total market capitalization of BGN 29 billion (EUR 14.8 billion). Annual trading value in 2007 was BGN 10 billion (EUR 5.1 billion). The market expanded significantly in recent years. For example, there were 81 new listings in 2007; the market capitalization to GDP ratio increased from 4% in 2002 to 41% as at June 30<sup>th</sup> 2007; and several Initial Public Offerings (IPO) occurred in the last few years. Several stakes in state-owned firms were sold on the stock market in 2003 and minority stakes in a large number of companies were disposed of in a series of centralized auctions in 2004 and 2005. An offer of 33% of the shares in the Bulgarian Telecommunication Company (BTC) raised about EUR 320 million in 2005 and, in 2007, 90% of the shares of BTC were traded on the stock exchange for more than EUR 1.4 billion<sup>13</sup>.

9. This A&A ROSC was planned and undertaken based on the aforementioned characteristics. Therefore, it outlines policy recommendations to enhance the quality and transparency of corporate financial reporting and seeks to foster a financial reporting platform conducive to more equitable and efficient tax collection and private sector growth and development.

<sup>11</sup> Financial Supervision Commission data

<sup>12</sup> Legal entity whose securities are admitted to trading on the stock market

<sup>13</sup> Bulgarian Stock Exchange data

## II. THE INSTITUTIONAL FRAMEWORK FOR ACCOUNTING AND AUDITING<sup>14</sup>

### A. The statutory framework for financial reporting, accounting and auditing

10. **Bulgaria became an EU Member State on January 1<sup>st</sup> 2007, and therefore its main body of law is the *acquis communautaire*.**

11. **Bulgarian commercial legislation is based mainly on the French and German civil law systems.** The Accountancy Act and the National Chart of Accounts were applied from the beginning of 1991, while National Accounting Standards were applied for the first time from the beginning of 1993. From January 1<sup>st</sup> 2002 to the date of accession of Bulgaria to the EU, a thorough accounting reform was carried out through the adoption of a new Accountancy Act (2001), the adoption in 2003 of International Financial Reporting Standards (called International Accounting Standards at that time), the creation in 2003 of National Financial Reporting Standards for Small and Medium-Sized Enterprises (NFRSSME), the adoption of the Independent Financial Audit Act (2003) (Audit Act), and repeal of the National Chart of Accounts. Then, with Bulgaria's accession to the EU in 2007, the legislation was substantially amended to comply with the EU First, Second, Fourth, Seventh, and Eighth Company Law Directives, as well as the Transparency Directive, the IAS Regulation, and the Banks and Insurance Accounts Directives. Furthermore, the Accountancy Act was modified to require companies that are over certain thresholds to use the International Financial Reporting Standards adopted by the European Commission (*endorsed IFRS*). Finally in July and August 2008, Bulgaria amended the Audit Act and the Accountancy Act to comply with the recently revised Eighth Company Law Directive.

12. **There are two specific Bulgarian accounting standards that need to be applied by relevant entities preparing their financial statements in accordance with *endorsed IFRS*:**

- Accounting standard No 9: Financial reporting of non-profit-making entities
- Accounting standard No 13: Liquidation and bankruptcy

13. **The requirements for financial reporting by companies apply equally to all limited liability companies, irrespective of ownership.** The companies in Bulgaria exceeding the thresholds stated in Table 7 have to prepare financial statements in accordance with *endorsed IFRS*.

**Table 7: Bulgaria accounting thresholds**

<b>If company exceeds either for the previous or for the current year at least two of the following criteria, it must use <i>endorsed IFRS</i></b>
<ul style="list-style-type: none"><li>• total assets at the end of the year greater than BGN 8 million (EUR 4 million)</li></ul>
<ul style="list-style-type: none"><li>• net sales for the year greater than BGN 15 million (EUR 7.7 million)</li></ul>
<ul style="list-style-type: none"><li>• average for the year greater than 250 full-time equivalent employees</li></ul>

14. **Entities that do not exceed the thresholds set out in Table 7 can choose whether they prepare their financial statements in accordance with *endorsed IFRS* or in accordance with NFRSSME.** However, enterprises, that issue securities to the public, credit institutions, insurance and investment companies, companies for additional social security and the funds managed by them, are obliged to prepare their financial statements in accordance with *endorsed IFRS*, irrespective of their size. The companies preparing their financial statements in accordance with NFRSSME must present their financial statements in a prescribed reporting format.

<sup>14</sup> 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.

15. **The requirements in respect of independent financial audits are in the Audit Act, the Accountancy Act, and the Market in Financial Instruments Act (2007) (Securities Act).** The Accountancy Act stipulates that the annual financial statements of the following entities are subject to an independent financial audit performed by registered auditors:

- joint stock companies and partnerships limited by shares
- enterprises that are listed companies within the meaning of the Securities Act
- credit institutions, insurance and investment companies, companies for additional social security and the funds managed by them
- other enterprises for which this requirement is provided by law
- all other enterprises not mentioned above, with the exception of enterprises applying a simplified form of financial reporting (Table 8) and budget-funded enterprises

**Table 8: Bulgarian enterprises applying a simplified form of financial reporting**

If enterprise does not exceeds either for the previous or for the current year at two of the following criteria
<ul style="list-style-type: none"> <li>• total assets at the end of the year BGN 1.5 million ( EUR 770,000)</li> </ul>
<ul style="list-style-type: none"> <li>• net revenue for the year BGN 2.5 million (EUR 1.3 million)</li> </ul>
<ul style="list-style-type: none"> <li>• average for the year 50 full-time equivalent employees</li> </ul>

16. **All listed companies are required to send a copy of their annual report, including the audited financial statements, to the FSC and the Bulgarian Stock Exchange within three months after their year-end.** The listed company shall publish a notice of the submission of the financial statements. Entities must also file their financial statements with the Registry Agency by June 30<sup>th</sup> of the following year. Copies of the audited financial statements of all listed companies are available to the public, the majority of them through the Bulgarian Stock Exchange and the Registry Agency websites. However, the companies may present their financial statements on different media (official gazette, company website, etc...).

17. **Listed companies on the Bulgarian Stock Exchange are required to prepare annual and quarterly financial statements in accordance with *endorsed* IFRS.** Only annual financial statements are required to be audited.

18. The following table provides an overview as of November 2008 of the general legal requirements for preparation and audit of financial statements for each type of legal entity:

Table 9: Legal requirements for preparation and audit of financial statements

Type of entity	Financial reporting standards for individual financial statements	Financial reporting standards for consolidated financial statements	Annual audit	Filing and publication of financial statements
Listed companies	<i>Endorsed IFRS</i>	<i>Endorsed IFRS</i>	Required	Registry Agency, FSC and Bulgarian Stock Exchange
Joint stock companies that are not listed	If large then <i>endorsed IFRS</i> , otherwise <i>endorsed IFRS</i> or <i>NFRSSME</i>	Same standards as individual financial statements	Required	Registry Agency
Small and medium sized companies that are not listed	If large then <i>endorsed IFRS</i> ; otherwise <i>endorsed IFRS</i> or <i>NFRSSME</i>	Same standards as individual financial statements	Required with the exception of companies applying a simplified form of financial reporting set out in Table 8	Registry Agency
Banks	<i>Endorsed IFRS</i>	<i>Endorsed IFRS</i>	Required	Registry Agency and BNB
Insurance undertakings	<i>Endorsed IFRS</i>	<i>Endorsed IFRS</i>	Required	Registry Agency and FSC
Companies for additional social security and the funds managed by them.	<i>Endorsed IFRS</i>	<i>Endorsed IFRS</i>	Required	Registry Agency and FSC

## Financial Sector Entities

19. Banks, insurance companies, investment funds, and pension funds are required to apply *endorsed IFRS* for financial reporting purposes. While the regulators and the National Revenue Agency (NRA) accept *endorsed IFRS* as a basis for financial reporting, it is important to note that, in addition to the filing of financial statements, banks, insurance companies, investment funds, and pension funds are obliged to submit prudential reports to the BNB (banks) and the FSC (other).

20. Although based on *endorsed IFRS*, prudential reports may apply principles that differ slightly from *endorsed IFRS*. For banks, the BNB requires a different approach for loan loss provisioning. For insurance companies, the FSC requires a different approach to reserving. These different approaches may result in provisions or reserves, respectively that differ from those included in financial statements prepared in accordance with *endorsed IFRS*. In addition, the BNB and the FSC require breakdowns of information in financial statements, as well as additional information to help monitor prudential risks. Such differences can be justified by appropriate supervisory considerations, including different approaches to risk. The BNB recently adopted the Consolidated Financial Reporting (FinRep) templates issued by the Committee of European Banking Supervisors (CEBS) for the purpose of prudential reporting by banks. This is designed to harmonize regulatory reporting with *endorsed IFRS* to the maximum extent possible and to reflect the approach of using “prudential filters” to adjust *endorsed IFRS* financial statements for purposes of calculating regulatory capital, thereby reducing the additional reporting burdens for supervisory purposes. This greater alignment of regulatory and general purpose financial reporting also enhances the market discipline role of financial information made available to the public.

## **B. The Accounting and Auditing Profession**

### *B.1. The Accounting Profession*

21. **Bulgarian legislation includes requirements for financial statement preparers to meet minimum education and experience levels.** The required level of experience ranges from two to eight years depending on the level of education achieved.

22. **The accounting profession remains fragmented, the result being low institutional capacity.** There are four accounting associations, two for individuals (Institute of Professional Accountants in Bulgaria with ~100 members; Union of Accountants with ~500 members) and two for accounting firms (Association of Professional Accounting Companies with ~60 members; Association of Accounting Offices with ~20 members). None of the associations operates a certification program or performs other functions ordinarily associated with a professional association. Many accountants seek to get the Association of Chartered Certified Accountants of the United Kingdom (ACCA) accreditation as there is no Bulgarian accountancy certification. The absence of a legislative foundation for the accounting associations, combined with the lack of a professional certification process, results in the associations being merely voluntary groupings of members with a common interest rather than true professional accountancy organizations.

23. **The absence of quality assurance, investigation and discipline processes relating to the work of accountants, as well as a lack of enforcement, results in a situation in which SMEs representing a significant part of the economy prepare financial information that is not subject to any form of monitoring, supervision, or enforcement.** For many such enterprises, income tax considerations are a primary concern and those considerations tend to drive financial reporting, irrespective of relevant accounting standards. This is exacerbated by the fact that often the same individual provides both accounting, auditing and income tax services to SMEs.

24. **Access to records may not always be provided by clients.** As is the case in some other countries in the region, external accountants record and report only such information as is provided to them by business owners and, as a result, financial reporting may be incomplete. This is a result of the still-prevailing perception among many business owners, particularly in the SME environment, that financial reporting does not provide them with useful information and is useful for income tax purposes only. The profession needs to promote sound financial reporting as an essential element of commercial success.

### *B.2. The Audit Profession*

25. **The right to conduct statutory audits of financial statements is reserved to registered auditors.** The Audit Act, as recently amended, recognizes that the profession is subject to public oversight and requires that the Institute of Certified Public Accountants of Bulgaria (ICPAB) ensure the performance of the profession in the interests of society. Among procedures that the Audit Act requires of the ICPAB are the following:

- organize and conduct professional examinations
- register auditors, maintain and publish annually in the State Gazette the register of auditors – sole practitioners and audit firms
- organize training for auditors
- approve internal control systems of members' activity and compliance with professional ethical standards
- develop a professional code of ethics for its members

- develop, if necessary, professional audit rules and techniques
- control the quality of audit activity and the professional conduct of its members

26. **The government of Bulgaria recently adopted amendments to the Accountancy Act (August 2008) and the Audit Act (July 2008) to comply with the EU Eighth Company Law Directive.** The amendments set the base for creation of a public oversight system for registered auditors and improvement of the system of quality assurance. Properly implemented, this will profoundly improve enforcement and should result in better quality audit work. These amendments added the following responsibilities for the ICPAB:

- develop a draft annual work program to be submitted for approval by the Public Oversight on Registered Auditors Committee (Committee)
- develop and submit to the Committee a report on its activities
- support the activities of the Committee.

27. **The ICPAB, created in 1996, has 568 individual members, of whom approximately 200 are sole practitioners, and 88 audit firm members.** Audit firms include local member firms of all the major international networks, as well as purely local firms and sole practitioners. The number of registered auditors has not changed significantly since 2002 (570). Universities complain that many students do not want to choose this profession, as it is too difficult to pass the ICPAB professional exams. For example, 6 to 8% on average in the last few years and only eight people passed the exams in 2007. Furthermore, representatives of audit and accounting firms mentioned that, even if the examination process has improved, it is not unusual that candidates who have passed the international ACCA exams, fail the ICPAB professional exams. There is a perception that there are some barriers to entry. The low success rate of the candidates is attributed by the ICPAB to: a) slow, if any, improvement of the university syllabus, b) significant increase in the volume of *endorsed* IFRS and International Federation of Accountants' (IFAC) standards, and c) Bulgarian legislation complexities and sophistication.

28. **In accordance with the recently amended EU Eighth Company Law Directive, the Audit Act requires that registered auditors adhere to the highest ethical standards.** As required by the Audit Act, the ICPAB's professional code of ethics is based on the IFAC Code of Ethics. The following ethical principles need to guide the auditor: independence, objectivity, professional competence (including knowledge of *endorsed* IFRS and ISA), confidentiality, professional conduct, integrity, responsibility, and knowledge and ability to implement professional standards. The revised IFAC Code of Ethics was translated into Bulgarian and adopted in 2006. Even though an adequate formal structure exists to investigate and discipline breaches of the Code of Ethics, it is believed that enforcement needs to be improved. In 2007, close to 200 registered auditors and audit firms were inspected by the ICPAB but few problems of ethics were raised.

29. **Registered auditors in Bulgaria are now subject to limited liability relating to their audits.** In the past, while a majority of audit firms in Bulgaria had limited liability companies, audit opinions were signed in the name of an individual registered auditor, resulting in unlimited personal liability for these individuals. As recommended by the EU, in July 2008, the Audit Act was amended to limit the liability of registered auditors. Liability for damages suffered as a direct and immediate consequence of an auditor's actions is now limited to three times the fees received for the audit. The limitation of liability does not apply, however, in the case of intentional wrongful behaviour by the auditor.

30. **The Audit Act stipulates that management of an enterprise shall provide the external auditors with the financial statements prepared by the staff of the enterprise.** A significant improvement has been achieved in many larger or foreign-owned enterprises in that accounting staff of these enterprises are currently sufficiently competent to prepare financial statements without the auditor's assistance. In many small enterprises, however, further efforts

are needed to bring the staff knowledge and skills for the preparation of financial statements up to the required level. This would eliminate the involvement of auditors in the financial statement preparation process, an involvement that may threaten the auditor's independence.

31. **The Insurance Act requires that the FSC accredit the external auditors of insurance companies.** There have been a few instances in the past when the FSC has withdrawn the accreditation of certain auditors. The ICPAB believes that such accreditation has no grounding in EU legislation and that there should not be two sets of measures for the registration of auditors.

### **C. Professional Education and Training**

32. **The Accountancy Act requires accountants (financial statements preparers) to have minimum education and professional experience but it is not clear to what extent this requirement is enforced in practice.**

33. **A registered auditor in Bulgaria must have acquired appropriate higher education, obtained relevant practical experience, and passed the ICPAB examination.** Registered auditors must accomplish the following:

- acquire higher education;
- depending on their education, obtain four to ten years practical experience of accounting, internal and external audit, and financial inspection in a National Revenue Agency and /or as a lecturer in the fields of accounting, control and finance, including two years with a registered auditor or audit firm; and
- then pass the ICPAB written examinations on accounting, commercial law, independent financial audit, taxation, and social security.

The practical training requirements are different to the ones from the EU Eight Company Law Directive of three years, with at least two thirds of such practical training completed with a registered auditor or audit firm.

34. **The Audit Act specifies the subjects on which the candidates must have passed exams before acquiring the right to sit for the ICPAB exams, as well as a list of subjects to be included in ICPAB exams.** The subjects of the required examinations combined with the subjects to be included in ICPAB exams do not address all the subjects required by the recently amended Eighth EU Company Law directive to be included in a test of theoretical knowledge. The important subjects that are not covered are: legal requirements and standards relating to the preparation of annual and consolidated accounts; legal requirements and standards relating to statutory audit and statutory auditors; professional ethics and independence, and the law on insolvency and similar procedure. The Audit Act may need to be amended and the ICPAB will need to change its exams to cover the missing subjects. The Audit Act may also need to be amended to recognize the possibility of qualification through long-term practical experience, or a combination of practical training and theoretical instruction. In addition, the ICPAB should prepare a policy to exempt candidates with university degrees from examination in certain subjects that were covered sufficiently in their university courses.

35. **According to the recent amendments to the Audit Act, successful candidates may sign audit reports, only after they have one year of professional experience in an audit firm or with a registered auditor and be registered with the ICPAB, in compliance with the recently amended Eighth EU Company Law Directive.** To be registered, auditors and audit firms are required to submit an application for membership and registration, with a court certificate of no convictions (for firms, partners and managers) and a certificate that he/she/firm complies with the Audit Act.

36. **While the above legislation complies with many aspects of the recently amended Eighth EU Company Law Directive, there is a perception that deficiencies exist in the implementation of training and certification arrangements, and that the education program does not meet IFAC's International Education Standards.** University and professional accountancy programs are not integrated and the disconnect results in a perception that university graduates are not prepared for professional studies. At the university level, there have been no significant changes since the last A&A ROSC report. As a result, many continue to believe that university education is not geared towards practical application, does not foster the use of judgment and principles underpinning *endorsed* IFRS, does not address ISA and provides few audit courses. It was observed that universities need instructors who are knowledgeable about international standards, have practical experience and follow current accounting and auditing current developments. Furthermore, there is a problem of study material for both instructors and students, as there are not enough text books and often the study material is obsolete.

37. **At the professional education level, some difficulties noted in the previous A&A ROSC report persist,** e.g., the lack of a true mentoring system for trainees, the lack of an accreditation mechanism for mentors and the lack of ICPAB monitoring of the quality of the three-year training program. Examination policies of the ICPAB do not appear to meet the standards proposed by IFAC and the examination process lacks transparency, leading unsuccessful candidates to allege impropriety.

38. **Auditors who registered prior to the date of effectiveness of the Audit Act were grandfathered after attending by January 1<sup>st</sup> 2003, 60-hours of training on *endorsed* IFRS and the ISA provided by the ICPAB.** The ICPAB carried out an extensive education program on the application of *endorsed* IFRS and the ISA with the assistance of bilateral technical assistance programs. This approach addressed the need for a significant number of registered auditors in a short period of time; however, it also led, in combination with almost no increase in the number of registered auditors, to a situation in which those firms having access to international networks have developed competencies required for audits done according to ISA, while sole practitioners and small local firms have not. There is some evidence of some registered auditors still not understanding the concept of an audit of financial statements. For example, some registered auditors “certify” that the financial statements are correct.

39. **The April 2002 by-laws of the ICPAB require its members to participate in a minimum of 40 hours per year of continuing professional development (CPD).** The ICPAB established CPD programs that it also operates. In addition, audit firms operate their own programs accepted by the ICPAB. Only formal CPD is permitted and documents providing evidence of compliance with requirements have to be attached to the annual declaration mailed to the ICPAB by each member. The ICPAB's supervisory board monitors the CPD done by registered auditors. So far, none were sanctioned or deregistered for non compliance. The ICPAB believes that imposing disciplinary measures was not well covered in the legislation, regulations and internal ICPAB rules; therefore any such steps, if taken, would have caused non-productive disputes and appeals. Further, it anticipates that by the end of 2008, with the recent amendments of the Audit Act and with the planned changes to the Statute of ICPAB, this will be resolved.

40. **Since *endorsed* IFRS are accepted as a basis for tax reporting, tax inspectors dealing with enterprises using this framework need to have an in-depth understanding of those standards.** The National Revenue Agency organizes courses for its staff, but these should be strengthened to give greater attention to the application of *endorsed* IFRS.



## **D. Setting Accounting and Auditing Standards**

41. **The Ministry of Finance (MoF) develops draft legislation for accounting and auditing.** Once draft legislation is prepared, it is sent to interested parties, including the BNB and the FSC. Accountants, registered auditors and companies, even if invited to participate in the consultation process, complained that they do not receive any feedback on their comments before amendments to legislation are made and that most of the time their views are not taken into account. There is a need for a more structured consultation process, where the resolution of comments is communicated to all participants.

42. **As demonstrated in the standards gap analysis, NFRSSME largely represent an abbreviated version of endorsed IFRS.** A majority of recognition and measurement requirements of NFRSSME are consistent with *endorsed* IFRS. Also, NFRSSME have a provision that refers the preparers to *endorsed* IFRS in the absence of specific accounting guidance. This requirement helps to minimize differences between NFRSSME and *endorsed* IFRS when there is no specific guidance in NFRSSME available. The NFRSSME disclosure requirements are significantly less extensive than in *endorsed* IFRS.

43. **The Bulgarian translation of endorsed IFRS is readily available and up-to-date.** Since Bulgaria joined the EU, the European Commission is in charge of translating the changes to *endorsed* IFRS, which are posted on the website of the Official Journal of the EU.

44. **Under the Audit Act, ISA are required to be used by external auditors.** These are translated by the ICPAB into Bulgarian and communicated to members. However, ISA that were recently redrafted as a result of the International Auditing and Assurance Standards Board's (IAASB) Clarity Project remain to be translated. The ISA are implemented by the ICPAB as soon as translated.

## **E. Enforcing Accounting and Auditing Standards**

45. **There is no specific institution performing permanent monitoring on compliance with NFRSSME or endorsed IFRS in general purpose financial statements.** The BNB monitors the financial reporting of banks for regulatory purposes; the MoF monitors and analyses the financial position of state-owned and municipal entities; the National Revenue Agency (NRA) takes action in case of violation of the accounting legislation uncovered in the course of a tax inspection; and the ICPAB monitors registered auditors and the audits they perform.

46. **Even though legislation requires filing of financial statements with the Registry Agency, this requirement is often not met.** Similarly the FSC took action against 33 companies in 2007 (24 in 2006) in relation to non-filing or delayed filing of quarterly and annual accounts. Sanctions for non-compliance with the financial reporting requirements remain low and there are many instances of enterprises not preparing financial statements at all, except for the information required for income tax purposes. The FSC ordered total fines of BGN 67,500 (EUR 34,512) in 2006-2007, an average of BGN 1,184 (EUR 605) per non compliant company. While the sanctions foreseen under the Securities Act include civil liability for the preparers, the directors, and the registered auditors, no court case has been reported to date.

47. **As in 2002, the FSC has limited resources (15 staff for monitoring activities) to review listed companies' financial statements and relies almost entirely on auditors to check compliance with accounting standards.** There was only one case of mandatory restatement ordered by the FSC in 2007 although the compliance gap analysis revealed that there is scope for significant improvements. The FSC staff's professional backgrounds are in economics, business, law and computer sciences but none are Certified Public Accountants.

48. **The Bulgarian stock exchange does not review the quality of financial statements presented by joint stock companies.** Instead, the stock exchange monitors that documents and reports required to be filed by listed companies are lodged in line with the reporting requirements of the exchange (Table 10).

**Table 10: Reporting to the Bulgarian Stock Exchange**

Type of report	Deadline
Quarterly financial statements	30 days after end of quarter
Annual report	90 days after end of financial year
Consolidated financial statements	120 days after end of financial year

49. **The annual report (called “annual financial report on the activities” in the law) to be submitted to the stock exchange must contain the following documents:**

- annual financial statements
- auditor’s report
- annual activity report
- program for the application of internationally recognized standards of good corporate governance
- written statements by the responsible persons within the listed company certifying that, to the best of their knowledge:
  - financial statements present correctly and fairly the information about the listed company’s assets and liabilities, financial situation and profit or loss of the listed company and of the companies included in the consolidation
  - the annual activity report contain a truthful review of the development and results of the activity of the listed company, together with a description of major risks and uncertainties faced by the listed company

50. **Under the Audit Act, the chairman of the Managing Board of the ICPAB imposes sanctions for external auditors’ misconduct and violations.** These sanctions include fines from BGN 300 to 3,000 (EUR 150 to EUR 1,500), removal of the external auditor’s license to operate, suspension of the right to perform audits for a period of up to three years. The situation has not changed much since the 2002 A&A ROSC as the absence of an effective quality review system has resulted in few sanctions being levied.

### **Financial Sector Entities**

51. **The BNB reviews the financial statements of banks and the FSC the financial statements of insurance companies, investment funds, and pension funds.** Although the BNB and the FSC may request the ICPAB to withdraw an auditor’s registration, they have never done so.

52. **According to the banks, the BNB staff are very good at identifying issues with endorsed IFRS financial statements on an ongoing basis and discussing the issues with the preparers and, where necessary, the external auditors.** Based on the discussions with various stakeholders, the BNB appears to have a good level of *endorsed* IFRS expertise.

## **III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTISED**

53. The purpose of this section is to analyze the significant differences between NFRSSME and *endorsed* IFRS (the “standards gap analysis”) and the level of compliance of a sample of financial statements with NFRSSME and the *endorsed* IFRS (the “compliance gap analysis”) to identify any systemic non-compliance issues; the potential adverse impact on the reliability of financial statements of both gaps is also analyzed.

54. **The National Financial Reporting Standards for Small and Medium Enterprises (NFRSSME) have been in force since January 1<sup>st</sup> 2005.** NFRSSME replaced the National Accounting Standards (NAS), in place until December 31<sup>st</sup> 2004. NFRSSME were drawn up by the MoF in compliance with the EU requirements for legislative acts in the field of accounting (**Directive 78/660/EEC**, regulating preparation and presentation of individual financial statements and **Directive 83/349/EEC**, regulating preparation and presentation of group financial statements). The standards took into account *endorsed* IFRS. Since that time, there does not appear to have been a systematic process for reviewing NFRSSME to consider the need for updating in light of changes to *endorsed* IFRS.

### **Accounting standards gap analysis**

55. **Given that NFRSSME were enacted in 2005, based on *endorsed* IFRS at that time, there are some differences from *endorsed* IFRS as they exist currently:**

- NFRSSME include almost all accounting standards equivalent to *endorsed* IFRS, but require much less disclosure (IAS 12, 16, 17, 27, 28, 31, 33, 36, 39 and 41)
- NFRSSME do not include standards equivalent to the following *endorsed* IFRS:
  - IAS 14 Segment reporting
  - IAS 23 Borrowing costs
  - IAS 26 Accounting and reporting by retirement benefit plans
  - IAS 29 Financial reporting in hyperinflationary economies
  - IFRS 2 Share based payment
  - IFRS 4 Insurance contracts
  - IFRS 5 Non-current assets held for sale and discontinued operations
  - IFRS 6 Exploration for, and evaluation of, mineral resources
  - IFRS 7 Financial instruments disclosures.
- Some NFRSSME have differences from *endorsed* IFRS. A few examples include:
  - IAS 1 – Presentation of financial statements – net book value of assets and liabilities written-off due to natural disasters or assets expropriated. Special NFRSSME standard for companies in insolvency or liquidation.
  - IAS 2 – Inventories – last in first out (LIFO) as a cost formula is an allowed alternative.
  - IAS 8 – Accounting policies, changes in accounting estimates and errors – alternative approach for prospective recognition accepted.
  - IAS 16 – Property, plant and equipment – a separate NFRSSME on accounting for depreciation is adopted.
  - IAS 21 – The effects of changes in foreign exchange rates – the concept of functional currency is not adopted.
  - IFRS 3 – Business combinations – in NFRSSME, the pooling of interests method is allowed and negative goodwill is presented within assets in the balance sheet as part of the goodwill instead of being recognized immediately in profit and loss.

56. **While relieving SMEs of the burden of full compliance with *endorsed* IFRS is a measure that has broad support, the impact of the above differences on of financial statements prepared according to NFRSSME rather than *endorsed* IFRS may in some cases be significant.** It is therefore important to ensure that users of financial statements are familiar with NFRSSME and appreciate their limitations. NFRSSME should also be kept up to date through a systematic process that evaluates the need for change in light of revisions to *endorsed* IFRS and further work by the IASB to develop standards suitable for application by SMEs. However, in many cases the compliance gap noted below has a much greater impact on the reliability and usefulness of NFRSSME financial statements than the standards gap noted above.

## Accounting compliance gap analysis

57. **A sample of 18 financial statements prepared in accordance with *endorsed* IFRS<sup>15</sup> and 15 financial statements prepared in accordance with NFRSSME was reviewed.** These were obtained from the FSC, the Registry Agency website and the entities websites. Since the sample cannot be considered statistically valid the findings cannot be extrapolated to the entire population of Bulgarian financial statements. The findings are, however, a useful anecdotal indication of potential systemic problems in financial reporting.

58. **The selected financial statements were for the financial year ended 31 December 2006.** A general constraint for the application of *endorsed* IFRS for the financial year ended 2006 was the lack of translation into Bulgarian of *endorsed* IFRS applicable for the 2006 reporting period. This means that the accounting compliance gap analysis examined whether the financial statements were drawn up under the officially translated *endorsed* IFRS applicable as of January 1<sup>st</sup> 2005.

### *Endorsed IFRS financial statements*

59. **The sample of financial statements asserted to be prepared in accordance with *endorsed* IFRS included three banks, nine non-financial companies, three insurance companies, two investment funds, and one pension fund.** Audit reports from 15 entities were unqualified, two were qualified, and one was a disclaimer. The results of the review are set out below.

60. **The *endorsed* IFRS financial statements of banks were mostly compliant with the officially translated *endorsed* IFRS applicable as at January 1<sup>st</sup> 2005, but not with *endorsed* IFRS applicable for the financial year ended December 31<sup>st</sup>, 2006..**

61. **Financial statements of the nine non-financial companies showed evidence of non-compliance with *endorsed* IFRS.** Some of the wording of accounting policies and notes appeared to be standard wording, possibly drawn from model financial statements made available by the large audit firms, used without sufficient regards to the specific circumstances of the entity. Certain areas of non-compliance with standards with regard to presentation and disclosures were noted, as described below:

- IAS 1 - Presentation of Financial Statements. Finance costs were not separately presented on the face of the income statement and were offset against finance revenue; certain current liabilities were classified and presented as non-current.
- IFRS 3 - Business Combinations. No disclosures related to acquisitions made during the reporting period; the application of the purchase method of accounting, the costs related to a business combination, and their allocation of the purchase price to the identifiable net assets acquired, were not properly made.
- IAS 12 - Income Tax. No disclosures were made of the evidence supporting the recognition of deferred income tax assets on unused income tax losses and the change in income tax rate for 2006; separate disclosure for each temporary income tax difference of the amounts of deferred income tax asset or liability recognized in the balance sheet and the income statement were not made; the numerical reconciliation of the effective income tax rate to the nominal income tax rate was not included.
- IAS 19 - Employee Benefits. In several sampled financial statements there were no disclosures of defined benefit pension plans with regard to provisions for retirement benefits.

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<sup>15</sup> For the year ended in 2006, Bulgaria mandated the use of a translation of out of date *endorsed* IFRS and therefore did not apply *endorsed* IFRS.

- IAS 21 - Effects of Changes in Foreign Exchange Rates. One set of financial statements did not include the required disclosure of the functional currencies of the consolidated entities.
- IAS 24 - Related Party Disclosures. No disclosures about the categories of transactions, related party transactions, and key management personnel compensation.
- IAS 27 - Consolidated and Separate Financial Statements. In one of the sampled consolidated financial statements, investments in subsidiaries were not consolidated properly.
- IAS 28 - Investments in Associates and IAS 1, Presentation of Financial Statements. In one of the sampled consolidated financial statements, the share of profit or loss of associates accounted for using the equity method was not presented on the face of the income statement as well as disclosure of the associates' financial information, including the aggregated amounts of assets, liabilities, revenues, profit or loss was not made in the notes to financial statements.
- IAS 33- Earnings per share. Presentation of the earnings per share on the face of the income statement and comprehensive disclosure related to the earnings per share calculation in the notes to financial statements were not made.
- IAS 39 - Impairment of Assets. In one of the sampled financial statements, an impairment loss on property, plant and equipment, inventories and receivables was not recognized and the auditor issued a disclaimer of opinion.

**62. In addition to the specific non-compliance issues noted above for the non-financial companies, there were other minor compliance issues:**

- Missing disclosure with regards to inventories (IAS 2), property, plant and equipment (IAS 16), intangible assets (IAS 38), finance leases (IAS 17), and in one case a lack of reconciliation of the amounts of cash and cash equivalents in the cash flow statement with the balance sheet.
- Disclosure missing with regard to inventories related to the amount of inventories recognized as an expense during the period and the amount of any write-down.
- The useful lives and the depreciation/amortization methods used were not disclosed in several companies in relation to property, plant and equipment, and intangible assets.
- The net carrying amount of assets at the balance sheet date and reconciliation between the total minimum lease payments and their present value were not disclosed.

**63. Only one of the general purpose financial statements of the insurance companies reviewed included a liability adequacy test, which is a requirement of the IFRS 4 Insurance Contracts.** One of the insurance companies' financial statements reviewed was in the prudential format, which was not completely incorrect, but the presentation was not clear enough. Furthermore, one of the insurance company financial statements had some major disclosures of the IFRS 4 Insurance Contracts missing:

- liability adequacy tests results
- reinsurance
- deferred acquisition costs, including policies for recording
- areas of financial instruments for non-insurance activities, including investments activities
- not all the measurements appeared to be compliant with *endorsed* IFRS, and there was still significant room for improvement on disclosures required by *endorsed* IFRS.

**64. The financial statements of the pension and investment funds showed a number of possible non-compliance issues.** In some instances, there were accounting policies missing as well as other required disclosures included in the above points on missing disclosures and policies:

- Financial statements of the pension company that were reviewed included detailed disclosure of accounting policies, but still some disclosures were missing, while other were not needed, as they relate to periods prior to 2005. The basis of preparation was not pure *endorsed* IFRS, while the auditor's opinion was that these comply with *endorsed* IFRS.
- Financial statements of the asset management company that were reviewed were of good quality, but still some disclosures were missing.

**65. The financial statements of the financial sector entities, other than banks, also showed the following evidence of non-compliance:**

- In some financial statements the description of the basis of preparation (IAS 1) was inadequate as also mentioned above.
- In one set of financial statements an affiliate company was mentioned, but there was no disclosure of the accounting policy to account for the affiliate.
- There was no disclosure on commitments and contingencies where applicable.
- There were no full disclosures on related parties, e.g. prior years were missing and no amounts of the transactions were included; also there was no disclosure of the key management personnel compensation.
- There was no disclosure on employee retirement benefits in most of financial statements reviewed.
- There was no disclosure on events after the balance sheet date
- There was no disclosure on cash flow reconciliations.
- There was no disclosure of the reconciliation between NFRSSME and *endorsed* IFRS for insurance companies, as required by IFRS 1 First-time adoption of IFRS.
- The accounting policies to describe the classification of investments and the accounting treatment of fair value gains and losses were generally not disclosed, as required by IAS 39.
- Certain disclosure requirements of IAS 39 were not completely fulfilled, including:
  - missing details and explanations of fair value and sensitivity analysis on financial instruments
  - classification of financial assets, their impairment and derecognition
  - other financial liabilities and trade payables accounting policy
- Accounting policies were not full - certain disclosure requirements with regards to policies were not completely fulfilled or were missing, including:
  - cash and cash equivalents
  - deferred revenue
  - provisions
  - equity
  - finance costs
  - events after the balance sheet date
  - segment information
  - dividends
  - the impact of future required changes in accounting policies.

## NFRSSME financial statements

66. **A sample of 15 financial statements asserted to be prepared in accordance with National Financial Reporting Standards for Small and Medium-sized Enterprises (NFRSSME) was reviewed.** From these, 14 audit reports were unqualified and one was qualified.

- Some sets of attached underlying financial statements were not signed and stamped by the accounting firms who prepared financial statements as required by the Accountancy Act.
- It was also not clear whether the reviewed financial statements represented final audited financial statements.
- In some cases, the external auditors' reports were not properly signed and stamped.
- In most of the sampled financial statements, the accounting policies disclosed or the disclosures in the notes were very limited or non-existent. The measurement basis used, the specific accounting policies, and other disclosures required by NFRSSME were not made. In other cases the disclosures were confusing and misleading.
- In most of the cases, business activities of audited entities were not clear in financial statements.
- Disclosures as required by NFRSSME were not properly done with regard to related parties, investment properties, employee retirement benefits, significant financial risks relating to the stability of a company and computed profitability, efficiency, liquidity, financial independence and inventory turnover ratios.

## IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTISED

67. **In most of the *endorsed* IFRS financial statements the audit opinions referred to NFRSSME rather than to *endorsed* IFRS.** This is likely to be due to the fact that the financial statements were not fully compliant with *endorsed* IFRS, but rather with NFRSSME, which falls short of requiring compliance with the up-to-date translation of *endorsed* IFRS applicable for the relevant reporting period.

68. **In most instances, the audit opinions in the sampled financial statements did not include a paragraph as to the consistency of the directors' report with the accompanying financial statements, as required by the Accountancy Act.** In one instance the directors' report was not consistent with the accompanying consolidated financial statements, while it was consistent with the legal entity individual financial statements.

69. It was understood that the qualified audit opinions, and even the disclaimers of opinion, were not generally seen as major problems by the small and medium sized preparers, who are more focused on compliance with income tax requirements.

70. The audit profession believes that the sanctions for not having an entity's financial statements audited are too low, resulting in many small companies choosing to pay the penalties for not having their financial statements audited.

## V. PERCEPTION OF THE QUALITY OF FINANCIAL REPORTING

71. **In general, commercial banks appear to place little reliance on the financial statements presented by potential borrowers in determining whether to grant loans.** Bank loans are generally accompanied by the security of collateral or guarantees. Banks lend mostly based on the total sales of companies, business forecasts and site visits. However, the banks

noted that the fact that audited financial statements are available helps them to better trust a company.

72. **Financial analysts believe financial reporting has made great improvements in the last few years.** They attribute this progress to the opening of the capital markets, to better accounting standards and the decrease in the tax rate. They noted that annual reports include much more disclosure today than in the past and that there is more useful information for them and for investors. The advent of *endorsed* IFRS allows for the re-evaluation of assets and companies are taking this opportunity to reflect the real value of the companies. They believe the introduction of flat tax resulted in the simplification of the structure of companies that are now merging many affiliates created initially for tax saving purposes. They also believe Taxation rules continue to have a significant residual impact on financial reporting. For example, they believe reductions in corporate income tax rates may lead to move realistic reporting of net income in 2007. Further, they believe reductions in tax rates will contribute to the grey economy shrinking from 40% to 10%.

73. **Financial statements of large, especially listed, Bulgarian companies are “trusted” and are generally used as a primary source of information by investors, bankers and other stakeholders.**

74. **The availability of published financial statements in Bulgaria is not very good.** The filing requirements have changed since January 1<sup>st</sup> 2008. In accordance with the new requirements, all companies had to be registered with the Registry Agency and file their financial statements for 2007 by June 30<sup>th</sup> 2008. However, the agency did not have the capacity to handle the registration process and the effective implementation of this requirement has been postponed to 2010. The legislation was amended in June 2008 to allow the Registry Agency to hire more staff.

## VI. POLICY RECOMMENDATIONS

75. **The recommendations of this A&A ROSC are interrelated and mutually supportive.** Without attempting to provide a detailed tactical design for reforms, this report makes policy recommendations to support the implementation of accounting reform and to enhance the quality of corporate financial reporting.

76. **Work on the economics of information demonstrates that the role of information in a well-functioning economy enhance the reliability and availability of financial reporting and is conducive to:**

- strengthening Bulgaria’s financial architecture by increasing transparency about the financial condition and performance of public interest entities and enhancing the efficient operation of capital markets
- contributing to foreign direct and portfolio investment
- helping mobilize domestic savings
- facilitating investment decision-making by private pension fund managers
- facilitating the access of smaller-scale corporate borrowers, including small and medium enterprises, to credit from the formal financial sector by shifting gradually from collateral-based lending to lending based on the financial performance of prospective borrowers
- improving the assessment and collections of tax on corporate profits
- allowing investors to evaluate corporate prospects and make informed investment and voting decisions, resulting in a lower cost of capital and a better allocation of resources



- allowing shareholders and the public at large to assess management performance, thus influencing its behaviour (financial reporting is also a building block of a market-based monitoring of companies)
- assisting the authorities to monitor and reinforce compliance with the relevant portions of the *acquis communautaire*.

## Statutory framework

77. **Further enhancements to the statutory framework are needed.** In this context, the authorities may want to create a multi-disciplinary working group, including all relevant public and private sector stakeholders, to review the statutory framework with a view to assessing the effects of the *acquis communautaire* in light of Bulgaria's recent implementation experience as a new EU Member State. Due consideration should be given to the recent amendments to the Fourth, Seventh and Eighth Company Law Directives, and the Transparency Directive. Some issues on which the working group may want to focus include :

78. **Fully reflect all aspects of the new EU Eighth Company Law Directive in the accounting and auditing laws and regulations.** Matters that should in due course be reviewed to assess the need to make further amendments to the Audit Act include:

- Requiring that auditors from other Member States be tested on the adequacy of their knowledge of Bulgarian company, fiscal and social laws before being approved as registered auditors.
- Specifying the power of the state to decide whether an auditor should resign or abstain from an audit engagement in cases of self review or self interest threatening the auditors' independence.
- Giving the possibility of exempting from the requirement to have an audit committee PIEs that are collective investment undertakings with transferable securities admitted to trading on a regulated market.
- Stating that external auditors from third countries that audit listed companies should be registered and subject to quality assurance reviews, investigations and penalties. Derogations for reciprocity should be subject to equivalence testing.
- Adding that where the administrators or management body of an audit firm has no more than two members, one must be a registered auditor.
- Providing for withdrawal of the approval of an auditor if the good repute of that auditor has been seriously compromised or any of the basic conditions to be approved are no longer fulfilled and communicating the fact and the reasons for the withdrawal to relevant competent authorities of Member States where the auditor is also approved.
- Providing in the ICPAB tests of theoretical knowledge for the following additional subjects:
  - legal requirements and standards relating to the preparation of annual and consolidated accounts
  - legal requirements and standards relating to external audit and external auditors
  - company law and corporate governance
  - the law of insolvency and similar procedures.
- Specifying that all training is carried out with persons providing adequate guarantees regarding their ability to provide practical training.
- Allowing for the approval of an auditor on the basis of long-term practical experience, and a combination of practical training and theoretical instruction.
- Exempting PIEs that have not issued transferable securities admitted to trading on a regulated market and their auditors from one or more of the requirements for audit of PIEs.
- Requiring the rotation of external auditors of PIEs to reinforce their independence.

- Specifying clearly that the public oversight system has the ultimate responsibility for the oversight or the approval and registration of external auditors and audit firms.

79. **Establish a more structured consultation process for the drafting of amendments to accounting and auditing laws.** It should include feedback to participants in the consultation process of resolution of comments. Ideally, feedback should be provided on their comments before amendments to legislation are finalised.

80. **Amend the Securities Act to require the filing of half-yearly financial reports for listed companies.** While the requirements of the Bulgarian Stock Exchange appear to conform to the EU Transparency Directive, the working group should ensure Bulgarian legislation is also aligned with it. The EU Transparency Directive, which should have been transposed by Member States no later than January 20th 2007, requires listed companies to prepare and present annual financial reports and half-yearly financial reports, including consolidated financial statements, within four months of the year end and two months of the end of the semester, respectively. The Securities Act covers the filing of annual financial reports but it should be amended to add filing requirements for half-yearly financial reports covering the first six months of the financial year. These half-yearly financial reports should include a condensed set of financial statements, an interim management report and statements by the persons responsible within the listed company.

81. **Revise the legislation on the appointment of external auditors and access to their working papers by regulators.** The working group may want to propose amendments to existing laws so that the BNB and the FSC are given the authority to veto the appointment of an auditor in insurance companies, banks and listed companies, respectively. Further, the BNB and the FSC should be informed in advance of the proposed appointment of auditors of banks, insurance companies and listed companies, respectively, and have power to enquire about the capacity of the auditor that will carry out the engagement to ensure the auditor meets established standards of practice (e.g., technical competence, independence from the client, etc...). The working group should ensure that the laws provide the BNB and the FSC with access to the external auditors' working papers. This will create a sound framework to fully leverage the work of registered auditors.

82. **Eliminate conflicting or ambiguous financial reporting requirements.** The working group should review the Bulgarian legal framework to ensure there are no conflicting or ambiguous financial reporting requirements. In this context, the working group should ensure that the financial sector regulatory requirements do not create conflict with endorsed IFRS financial statements. Where the regulators need additional (unpublished) information for prudential supervision purposes, this now comes by topping up endorsed IFRS. The regulators therefore would have a keen interest in ensuring that the endorsed IFRS financial statements are correct (since prudential reports are built on that foundation). This should enable their resources to be mobilized to assist in enforcement of endorsed IFRS compliance in shareholder or stakeholder-oriented financial statements.

## **Accounting and auditing standards**

83. **Bulgarian institutions should be provided with the resources to participate actively and systematically in the European policy-making process through an active role in relevant EU Committees.** This is important not only to keep abreast of ongoing changes to the *acquis communautaire* but also to allow Bulgaria to promote policies that are in its national interest, and to prevent decisions that could cause difficulties in practical implementation at the national level. This necessarily involves effective participation by Bulgarian institutions in relevant EU advisory committees

## Monitoring and enforcement

84. **Bulgaria needs to strengthen the institutionalized incentives for rigorous application of high quality financial reporting requirements in the corporate—financial and non-financial—sector.** Prior to EU accession stakeholders have focused on aligning the regulatory framework with the requirements of the *acquis*. In this early stage after accession, the authorities and relevant stakeholders should seek to put in place proper incentives to ensure that the *acquis communautaire* is actually applied in practice. Market forces provide certain positive incentives to comply with high standards but experience suggests that countervailing perverse incentives operate to discourage such compliance. Drawing on recent reforms in several OECD countries, more emphasis should be placed on the deterrent effect of robust enforcement regimes. Scarcity of appropriate and informed resources is a clear and immediate problem but one that may not be able to be addressed fully in the short term. While encouraging the development of a dedicated and experienced enforcement resource, the recommendations seek, as a priority, to address how the FSC might make more effective use of the limited resources it has by:

- targeting and focusing its monitoring activities with a view to achieving measurable targets in a short time-frame;
- encouraging a culture of compliance on the part of financial statements preparers and users; and
- increasing its deterrent effect through example supported by education – thereby reducing the need, over the longer term, for regulatory intervention and improving cost effectiveness.

The following recommendations are designed to promote a balanced combination of capacity, incentives and deterrence to increase on the ground compliance with the *acquis*.

85. **Make operational the public oversight system envisaged by the amended legislation as soon as possible.** The existing quality assurance systems should have adequate public oversight consisting of a majority of non-practitioners. The purpose of the oversight body is to ensure that quality assurance is, in fact and appearance, an exercise with sufficient public integrity and meets the objective of sustaining public confidence and demonstrating to regulators the adequate discharge of self-regulating responsibilities.

As noted above, institutional investors, commercial banks and other users of audited financial statements pointed to an uneven profession where a number of registered auditors who were grandfathered into the profession in 2003 may not have been subject to the same professional qualification requirements as the more recently certified auditors. The public oversight system should ensure that all registered auditors are subject to a quality assurance review and related disciplinary sanctions.

The recent amendments to the Audit Act cover most of these elements and specifically address the following issues:

- The quality assurance system should be organized in such a manner that it is independent of the reviewed auditors and audit firms and subject to public oversight.
- The funding for the quality assurance system should be secure and free from any possible undue influence by auditors and audit firms.

86. **Ensure greater transparency of registered auditors and audit firms who audit PIEs, in accordance with the recently amended Eighth EU Company Law Directive.** To comply with the directive, Bulgaria recently amended the Audit Act to require registered auditors and audit firms to publish on their website, within three months of the end of each financial year, annual transparency reports. Registered auditors and audit firms should include in this report the legal structure and ownership; if with a network, a description of this network; a description of the governance structure of the audit firm; its internal quality control system and a statement on its functioning; an indication of when the last quality assurance review took place; a list of public-interest entities for which the audit firm has carried out statutory audits during the preceding financial year; a statement of the audit firm's independence practices; its policy concerning the continuing education of registered auditors; financial information showing the importance of the audit firm and the basis for the partners' remuneration. This would encourage external auditors and audit firms to exercise high standards of care with respect to the quality of their work and ensure that quality weaknesses are addressed rapidly.

87. **Introduce greater transparency to the ICPAB's quality assurance and disciplinary procedures.** Quality assurance is the profession's principal means of assuring the public and regulators that registered auditors and audit firms are performing at a level that meets the established auditing standards and ethical rules. It is necessary to have a systematic link between negative outcomes of quality reviews and initiating sanctions under the disciplinary system. As a minimum:

- An annual quality assurance report, giving a summary of quality assurance activities and statistical information regarding the outcomes of visits, should be published.
- Decisions taken by the Disciplinary Committee regarding referrals to the courts should be justified and subject to review by a public oversight body.
- The proceedings and decisions of the courts should be published and remain in the public domain.

In addition, the uncertainty regarding confidentially arrangements should be clarified so that inspectors have the right to require the production of audit work papers, and any other document or information in the possession of the audit firm, or any associated person thereof.

88. **Create a FSC dedicated unit with clear authority and responsibility for monitoring of financial information.** The unit needs to be staffed by appropriately experienced and senior personnel. Given the number of listed companies, the unit needs to comprise an adequate number of staff with clear public responsibility for the monitoring function. The unit would not be available for other functions of supervision—except for consultation and analysis on technical issues—and needs to develop a public profile that is distinct from other functions of the FSC. A secondment of an existing senior staff member to a regulatory body of another Member State might be considered as a practical means of enhancing knowledge and understanding of how such a unit might be developed. The unit should consider the following:

- developing a targeted approach to the monitoring of financial information consistent with the risk-based approach identified in the CESR (Committee of European Securities Regulators) Standards of Enforcement
- developing a sophisticated review of financial information consistent with the principles based approach of endorsed IFRS
- using the gateways that have been put in place through recent legislation and side agreements to share information with other regulators to work together to improve in the presentation of financial information
- evaluating whether it has a full complement of enforcement powers appropriate to its function.

89. **Review the FSC required prudential reporting from insurance companies, investment funds, and pension funds, to ensure that it is founded upon *endorsed* IFRS.** The FSC also needs to re-evaluate prudential reporting requirements to ensure that they are comparable to those of similar regulatory agencies in other countries and eliminate any unnecessary regulatory reporting burden on insurance companies, investment funds, and pension funds.

## **Profession and ethics**

90. **Enhance statutory audit quality and public trust in the audit profession.** While the transposition of the recently amended Eighth EU Company Law Directive's requirements should establish a sound framework for enhanced accounting and audit quality, the profession must address the following areas of immediate concern:

91. **Increase the capacity of the ICPAB to enable it to make a more effective contribution to the Bulgarian auditing profession.** There should be a detailed review of the activities required of the ICPAB. In this regard, a twinning arrangement with a respected European professional body should be considered. Among other things, the ICPAB needs to introduce:

- a technical advice help desk service for members; and
- a standard audit methodology and audit program pack for small audit firms.

To do this the ICPAB will need full time professionally qualified technical staff, who will ensure that the full requirements of ISA are incorporated into the standard materials. We also recommend that the ICPAB consider how it can take advantage of work currently being undertaken by IFAC to assist small audit firms in performing high quality audits that comply fully with ISA.

## **Training and education**

92. **Update and modernize the ICPAB syllabus to comply fully with the Eighth Company Law Directive and to meet education standards established by IFAC.** Clearly, the instances where NFRSSME differ from *endorsed* IFRS need to be retained in the syllabus, but the main thrust of the syllabus content as it relates to accounting should be directed at the provisions of *endorsed* IFRS as this provides the fundamental underpinning for the Bulgarian financial reporting system, particularly for PIEs.

93. **Intensify the training for tax inspectors on the *endorsed* IFRS.** As highlighted in 2002 and as noted during a recent meeting with the NRA staff, there is still a need for better and more intensive training for tax inspectors for them to better understand *endorsed* IFRS.

94. **Rationalise the accounting and auditing education to develop a continuum from university education through to professional qualification.** Given the clear policy of Bulgaria in adopting *endorsed* IFRS and ISA as the basis for accounting and auditing, it is important that these principles are incorporated into every level of accounting education and that the education continuum becomes increasingly integrated with each subsequent level building upon the previous level. In this way, the underlying principles of *endorsed* IFRS and ISA will become established as the norm within the Bulgarian accounting and auditing profession, and accounting reform will become increasingly more effective. For this to be achieved, a close relation of universities with the ICPAB would be necessary.

95. **Cover in more detail *endorsed* IFRS and ISA in accountancy education at university level with instructors who have practical experience and can provide appropriate student study material.** Currently, most accountancy education at university level is based on NFRSSME although, as noted in this report, some movement towards *endorsed* IFRS has been made at the University of National and World Economy. These developments should be replicated in other universities and colleges so as to facilitate the supply of accountants that are conversant with *endorsed* IFRS. The following additional recommendations relate to universities:

- The syllabi and teaching approaches for university courses with significant accounting and auditing components should be reviewed to ensure that they reflect the latest versions of *endorsed* IFRS, ISA and current legislation in Bulgaria. Emphasis should be placed on better integration of university programs with professional certification and licensing requirements.
- The providers of accounting and auditing education in Bulgaria, including university lecturers and professional trainers, should be given the necessary support and assistance to update their knowledge and skills to include the latest international best practice in accounting and auditing, including *endorsed* IFRS and ISA. This will require a major program of re-tooling accounting lecturers at universities, particularly in the state sector, and could also require some tuition in the English language in which much relevant technical material is published.
- Greater support should be given to activities aiming to standardize and raise the quality of university accounting and auditing education programs nationwide. Supporting these activities may help achieve many of the other recommendations set forth in this section, including updating and enhancing university syllabi to be compliant with the most recent *endorsed* IFRS and ISA, assisting university professors in keeping their accounting and auditing knowledge current and aligning university education programs with professional qualifications.
- Bulgaria needs to continue its efforts to unite and coordinate provision of accounting education and training with the interests of the professional accounting community, bringing together professional organizations, university educators, relevant Government ministries and leading international and local professional accounting firms to increase the market orientation of accounting courses. This would result in a steady supply of accountants with knowledge and experience relevant to the needs of Bulgaria.