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REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)

Bulgaria

ACCOUNTING AND AUDITING

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Contents

Executive Summary

Financial reporting and auditing requirements in Bulgaria are currently in a period of transition from compliance with national standards to compliance with International Accounting Standards (IAS), International Standards on Auditing (ISA), and the European Union (EU) Directives and Regulations. A new Accountancy Law came into effect in 2002 and seeks to attain maximum compliance with the EU Fourth and Seventh Directives and to create an environment for the comprehensive implementation of IAS for both legal entity and consolidated financial statements in 2003/2005. A new Independent Financial Audit Law came into effect in 2002 and seeks to attain compliance with the EU Eighth Directive and ISA beginning in 2003.

The transition to full IAS compliance will be demanding. It requires extensive education in a different style and philosophy of accounting requirements. The transition is made all the more difficult by the decision to require all entities to comply with IAS. This is a much greater burden than applies in any EU Member State. Finally, the transition to full IAS may face considerable push back from regulators who fail to differentiate between general purpose and regulatory financial statements.

There is currently no effective enforcement of compliance with national accounting standards and there are conflicting opinions about the effectiveness of the audit quality control reviews carried out by the Institute of Certified Public Accountants of Bulgaria (ICPAB). While ICPAB is aware of the challenges it faces, the transition to full ISA audits requires extensive education and strict enforcement of standards by the profession. This report draws upon recent international experience in developed economies and recommends that the current self-regulation of the audit profession should be reviewed and an adequate oversight mechanism established.

This report was prepared by a team from the World Bank on the basis of the findings from a diagnostic review carried out in Bulgaria in April and October 2002. The staff team comprised John Hegarty (ECSPS) and Frédéric Gielen (ECSPS). The review was conducted through a participatory process involving various stakeholders and led by the country authorities.

I. INTRODUCTION

1. An assessment of accounting and auditing practices in Bulgaria is a part of the World Bank and the International Monetary Fund (IMF) joint initiative on Reports on the Observance of Standards and Codes (ROSC). The assessment focused on the strengths and weaknesses of the accounting and auditing environment that influences the quality of corporate financial reporting. It used the International Accounting Standards (IAS)[1] and the International Standards of Auditing (ISA) as benchmarks. It involved a review of both mandatory requirements and actual practices.

2. Following the return to a market economy in the late 1980s, Bulgaria commenced an extensive privatization program. The country made significant revisions to its laws on accounting, auditing, and securities regulation, in part, to attract domestic and foreign investors. There are about 380 joint stock companies traded on the Bulgarian Stock Exchange, of which 30 companies represent the top tier and 350 companies, the unofficial market (formally known as the "free market").[2] There is however limited trading in securities and a significant shortage of both liquidity and new issues. There are approximately 800,000 small or medium enterprises (SMEs), of which about 200,000 are limited liability companies and about 600,000 are sole traders (proprietors).

3. Since 1990, Bulgaria's economic orientation has increasingly moved toward western Europe, with European Union (EU) membership a consensus goal among country leadership. EU membership is currently planned for 2007 and has been a driving force in adopting such reforms as the Accountancy Law 200l and the Independent Financial Audit Law 2001.

II. INSTITUTIONAL FRAMEWORK

A. Statutory Framework

4. **Under the Accountancy Law 1991 (as amended), all companies had to present legal entity and consolidated financial statements in accordance with the law, the National Chart of Accounts, and national accounting standards (NAS).** The NAS were determined by the Council of Ministers "in compliance with international accounting standards". A new version of NAS was published in 2002 and will remain in force until the end of 2004 when IAS will replace it. The legal entity financial statements were the primary financial statements. And these were the only financial statements

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1 Within this report, IAS refer to both International Financial Reporting Standards issued by the International Accounting Standards Board and the Standards issued by the Board of the International Accounting Standards Committee.

2 The "free market" was created in 1998 to list 1,054 enterprises privatized under the Mass Privatization Program (compulsory listing). The free market disclosure requirements were considerably less than those of the official market; for example, no offering prospectus was required. A subsequent change in the legislation allowed these companies to delist and the free market was renamed the "unofficial market". In spite of its name, trading, when any, occurs at the Stock Exchange.

approved by the shareholders. The consolidated financial statements were published up to three months later and were not submitted to the shareholders for approval.

5. **Under the Accountancy Law 2001, which went into effect on January 1, 2002, all private sector enterprises should present legal entity and consolidated financial statements in accordance with IAS "approved by the Council of Ministers".** It is understood that the Council of Ministers will approve all IAS so that full compliance with all IAS will be required. The Law includes several specific accounting requirements that are based on current IAS or the EU Directives but which may conflict with IAS in the future should the standards, but not the Law, be changed. Also, the Law includes several specific accounting requirements that conflict with existing IAS and may result in confusion:

- If the current proposal by the International Accounting Standards Board (IASB) to eliminate the concept of "extraordinary items" from IAS 8, *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*, is adopted, then articles 17.4 and 18.3 within the Accountancy Law 2001 would need to be amended.
- The requirement that an enterprise should publish legal entity financial statements within three months and consolidated financial statements within six months of the year-end is in conflict with IAS 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*, that requires a parent company presents consolidated financial statements.[3]

6. **From 2003, banks should present legal entity and consolidated financial statements in accordance with IAS.** The Bulgarian National Bank has the authority to mandate that the banks prepare their financial statements based on regulatory requirements (such as a formulaic approach to loan loss provisioning). The Bulgarian National Bank must be observant not to impose accounting treatments that may contradict IAS (such as the measurement of the loan portfolio under IAS 39, *Financial Instruments: Recognition and Measurement*).

7. **A new Law on Public Offering of Securities (LPOS 2002) went into effect on June 25, 2002.** LPOS 2002 requires among other things enhanced disclosure of financial and nonfinancial information upon initial public offering of an equity or debt security and on a regular basis thereafter. While LPOS 2002 establishes an enhanced framework for the protection of investors, it includes several accounting provisions that were clarified by the State Securities and Exchange Commission. For example, article 82.1.3 requires that a prospectus should include audited annual financial statements for the three preceding years. For all listing after January 1, 2003, issuers that did not prepare IAS financial statements until then are required to file with the regulatory agency their NAS-based audited annual financial statements for the three preceding years. This does not, however, eliminate the requirement for these issuers to disclose how the transition to IAS has affected the enterprise financial indicators.

[3] IAS 27 effectively requires that the consolidated financial statements should be issued contemporaneously with the legal entity financial statements.

8. **Under both the Independent Financial Audit Law 2001 and the Accountancy Law 2001, the financial statements of the following private sector enterprises should be audited by a registered auditor:**[4]

- Issuers of securities to the public;
- Other joint stock companies (i.e., unlisted);
- Partnerships limited by shares;
- Other banking and insurance enterprises and financial institutions (i.e., unlisted);
- Other large enterprises that prepare consolidated financial statements (i.e., unlisted); and
- Other large enterprises (i.e., unlisted).

9. **Under the Independent Financial Audit Law 2001, which went into effect on January 1, 2002, the audit should be carried out in accordance with ISA from July 1, 2003 (in practice, for the audit of 2003 financial statements).** The objective of the audit is to express an independent opinion on the fair presentation of the financial position, results, cash flows, and changes in equity in accordance with applicable accounting standards.[5] Under the Accountancy Law 1991 (as amended), the audit had to be carried out in accordance with National Standards on Auditing developed by the Institute of Certified Public Accountants in Bulgaria (in practice, until the audit of 2002 financial statements).

10. **Small and medium limited liability companies need not have their financial statements audited.** While the size limits were increased compared to the repealed Accountancy Law, they remain much lower than the limits in the EU Fourth Directive resulting in a small Bulgarian enterprise facing significantly greater audit burdens than their EU counterparts. Under the new law, the financial statements of an enterprise need not be audited when it does not meet at least two of the following criteria: total assets greater than 500,000 Bulgarian leva (US$260,000); operating revenue greater than 1 million Bulgarian leva (US$520,000); or more than 30 full-time equivalent employees.

11. **The Banking Act and the Insurance Act require that the Bulgarian National Bank and Insurance Supervision Agency accredit the auditors of banks and insurance companies, respectively.** The accreditation mechanism is not formalized and

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4 A registered auditor (individual or audit firm) is a member of the Institute of Certified Public Accountants in Bulgaria.

5 It appears that the Independent Financial Audit Law 2001 refers to the "fair presentation" (the U.S. approach) concept whereas the Accountancy Law 2001 refers to the "true and fair view" concept (the EU approach). The EU requires the auditor to opine on the presentation of a true and fair view and compliance with accounting standards, which is why there is a true and fair over-ride. A detailed review of the Bulgarian text may be warranted to determine whether the laws comply with the EU Directives in this regard.

no auditor or audit firm has ever had its accreditation withdrawn as a consequence of an audit failure. The Insurance Act requires that no less than two auditors audit the financial statements of an insurance company. These are typically two auditors belonging to the same audit firm, thereby significantly reducing the effectiveness of this joint audit requirement. The two acts also impose special reporting obligations on auditors of banks and insurance companies (e.g., obligation to inform the Bulgarian National Bank about any circumstance that may put the audited bank's activity at risk).

12. **Within three months of their approval for issuance, the legal entity financial and consolidated statements of all enterprises that are subject to audit should be published in a daily or economic publication, in an annual report, on the Internet, or in accordance with a separate law.** The financial statements should be published with the auditor's report and in the form in which they were audited. Banks, branches of foreign financial institutions, and insurance agencies should publish their balance sheets and income statements in the State Gazette. Pension insurance companies file their own audited annual financial statements, as well as the financial statements of the pension funds they manage, with the State Agency for Social Insurance Supervision and publish them in the State Gazette.

13. **All enterprises that issue securities to the public should send a copy of their annual report, including the audited financial statements, to the State Securities and Exchange Commission and the Bulgarian Stock Exchange within three months of year-end.** The issuer shall publish a notice of the submission of the financial statements. Paper copies of the audited financial statements of all listed companies are available at the Bulgarian Stock Exchange and the State Securities and Exchange Commission. The World Bank staff reviewed a sample of financial statements available on the website of the State Securities and Exchange Commission and noted that they (a) generally do not include disclosure notes on accounting policies or other non-numerical explanatory notes, (b) do not include a copy of the audit report, and (c) were not always up to date. While these financial statements complied with existing regulations, financial statements covering period starting after January 1, 2003, should be published with the auditor's report and in the form in which they were audited, with all the explanatory notes required by IAS. The State Securities and Exchange Commission is developing a modern, automated information system for the electronic transfer, reception, review, and distribution of data, including the full set of IAS financial statements.

14. **Erroneous or misleading annual reports do get published by issuers and widely distributed (both nationally and internationally).** Certain issuers publish glossy annual reports, including misleading audit reports (for example, a truncated audit report omitting the qualifications and "emphasis of a matter paragraphs") in English, and make them available through publication and the Internet. The supervisory institutions and the auditors do not appear to take action or to be successful in taking action to bar these issuers from disclosing erroneous or misleading financial information.

B. The Profession

15. **The Institute of Certified Public Accountants in Bulgaria (ICPAB) has 570 members, most of who are actively engaged in audit work.** Audit firms include local member firms of all the major international networks, as well as purely local firms and sole practitioners.

16. **The Independent Financial Audit Law (2001) recognizes that the profession is self-regulated and independent and requires that the ICPAB regulate the performance of the profession in the interest of society.** Among procedures that the Law requires of the ICPAB are the following:

- Organize and conduct professional examinations;
- Register auditors, maintain and publish special registers of auditors–individual persons and specialized 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; and
- Control the quality of audit activity and professional conduct of its members.

17. **The Independent Financial Audit Law (2001) requires that the ICPAB professional code of ethics should be based on the International Federation of Accountants (IFAC) Code of Ethics.** The Law also requires that the following ethical principles should guide the auditor: independence, objectivity, professional competence (including knowledge of IAS and ISA), confidentiality, professional conduct, integrity, responsibility, and knowledge and implementation of the professional standards. While reference to the IFAC Code of Ethics is a step in the right direction, the use of the term "based on" rather than "in accordance with" may create confusion and eventually weaken ethical standards. "Based on" may be construed as "based on the IFAC Code of Ethics topped-up to adequately capture issues specific to Bulgaria" or "based on the IFAC Code of Ethics less certain sections removed due to the political clout of certain members of the audit profession." Any deviation from the IFAC Code of Ethics should therefore require a due process and be endorsed by the audit profession oversight body recommended in paragraph 46.

18. **While the liability of registered auditors is unlimited, there have been no legal cases against auditors.** Auditors are required by law to take out professional indemnity insurance and the ICPAB is required to determine the minimum amount of such insurance, currently 10,000 Bulgarian leva (approximately US$5,200).

19. **The Independent Financial Audit Law (2001) stipulates that the management of the enterprise shall provide the auditors with the financial statements prepared**

by the enterprise. Observers note that many auditors prepare financial statements on behalf of their clients as a result of client's expectations and a general lack of financial reporting expertise. However most clients underline that audit firms generally transfer knowledge to their staff and gradually transfer the drafting of financial statements to the audited company.

C. Professional Education and Training

20. **A registered auditor must have acquired appropriate higher education, obtained relevant practical experience, and passed the ICPAB examination.** The Independent Financial Audit Law (2001) complies with the EU Eighth Directive by requiring that an auditor accomplish the following:

- Acquire higher education;
- Obtain four to ten years practical experience of accounting, internal and external financial audit, and tax administration (including at least three years as an assistant auditor); and
- Pass the ICPAB examination on accounting, commercial law, independent financial audit, taxation, and social security.

Successful candidates may sign audit reports only after a further three years in an audit firm or with a registered auditor. These requirements represent a significant enhancement over those that applied under the Accountancy Law (1991).

21. **While the above legislation complies with the EU Eighth Directive and the educational guidelines of IFAC, observers note deficiencies in actual training and certification arrangements.** While addressing critics, the new ICPAB leadership faces the challenge of revamping the implementation of these arrangements. The challenges include dealing with the subjectivity of the oral examination, 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.

22. **Universities have just started adapting their curriculum to the requirements of the new laws.** The lead time before students in the new curriculum graduate will range from three years (Bachelor's Degree) to five years (Master's Degree). Accounting education is made all the more difficult due to the lack of IAS training material in Bulgarian (textbooks, case studies, etc.).

23. **Auditors who registered prior to the date of effectiveness of the Independent Financial Audit Law (2001) will be grandfathered after attending, by January 1, 2003, 60-hours of IAS and ISA training provided by the ICPAB.** The ICPAB is currently carrying out an extensive education program on the application of IAS and ISA with the assistance of bilateral technical assistance programs. The adoption of IAS is reported to require more training than the adoption of ISA because there are more differences between NAS and IAS than there are between National Standards on Auditing and ISA. Furthermore, the adoption of IAS requires an understanding of the

philosophy behind IAS and adaptation to standards that contain less detail about specific accounting and, hence, require the exercise of greater judgment.

24. **While the grandfathering process is a major step in the right direction and will raise the level of awareness of auditors regarding IAS and ISA, it may not be sufficient to guarantee that auditors are fully proficient in IAS and capable of carrying out an audit in accordance with ISA**. The ICPAB has organized training programs and examinations in this regard. However certain observers point out two issues in the training process: (a) the 60-hour IAS and ISA classroom training can lay the foundation but certainly not enable an auditor to do an ISA-based audit of IAS-based financial statements, and (b) some training providers lack adequate practical experience in IAS and ISA.

25. **The April 2002 by-laws of the ICPAB require their members to participate in a minimum of 40 hours per year of continuing professional education (CPE).** The ICPAB established CPE programs that it also operates. It is not clear whether CPE programs offered by other institutions would qualify. As this requirement was introduced only recently, it is not clear how compliance with this mandatory requirement will be enforced by the ICPAB. The ICPAB indicated that the Institute would impose sanctions on members who fail to comply.

D. Setting Accounting and Auditing Standards

26. **Under the Accountancy Law (2001), compliance with IAS will be mandatory, therefore there should be no accounting "standards gap" for any companies.**

27. **Under the Accountancy Law (1991 as amended), there is a standards gap punctuated in several respects by the differences between NAS and IAS as identified in two recent studies.** PricewaterhouseCoopers (PwC) carried out a line-by-line comparison of NAS and IAS at the end of 1999 on behalf of the World Bank. The firm concluded that NAS were a "modified and significantly abbreviated version of IAS" and identified 13 substantial differences, as well as other less significant differences. The PwC report also drew attention to the considerable influence of taxation requirements on both the content and application of NAS. In a more recent study, *GAAP 2001—A Survey of National Accounting Rules,* seven leading accounting firms in Bulgaria identified approximately 25 differences between NAS and IAS at the end of 2001.[6] The differences will disappear fully when Bulgaria moves to full IAS compliance in 2003-2005.

28. **Under the Independent Financial Audit Law (2001), there should be no auditing standards gap, as all audits should be carried out in accordance with ISA.**

29. **A standards gap exists under the Accountancy Law (1991 as amended); although National Standards on Auditing are based on ISA, there are several differences.** The differences stem from either ISA adaptation when developing national standards or some ISA omission from national standards. The differences have reduced

[6] The methodology and survey can be found at http://www.ifad.net .

gradually as national standards have been developed. They will disappear fully when Bulgaria moves to full ISA compliance in 2003.

30. **Working under the jurisdiction of the Ministry of Finance, a committee that includes representatives of international accounting firms, and academe was established to translate IAS.** This arrangement relies on the goodwill of the committee members. The ISA have also been translated and edited in Bulgarian and will be published by April 2003.

E. Enforcing Accounting and Auditing Standards

31. **The State Securities and Exchange Commission reviews the financial statements of listed companies for completeness and compliance with applicable accounting standards.** The State Securities and Exchange Commission ordered five restatements in 2000 (none in 2001) and levied 22 fines for late filing. While the sanctions foreseen under the LPOS 2002 include civil liability for the preparers, the directors, and the auditors, no court case has been reported to date. In addition, the State Securities and Exchange Commission has limited resources to review issuers' financial statements and relies almost entirely on auditors to check compliance with accounting standards. While the 16 staffers of the State Securities and Exchange Commission in charge of this important function have a sound economics education and received NAS/IAS training, none is a certified public accountant. They indicated and observers confirmed that there is a need for additional IAS training, especially as the business environment and the related accounting treatment become increasingly complex.

32. **The Bulgarian National Bank reviews banks' financial statements, but the primary responsibility rests with the auditors.**[7] Although the Bulgarian National Bank has the authority to withdraw an auditor's accreditation, it has never done so because no discrepancies have been found beyond doubt. However, the Bulgarian National Bank is working on a draft regulation for the content of the auditor's report on the banks' annual financial statements. The regulation will introduce clear criteria and requirements to the auditors on the basis of which the Bulgarian National Bank will be able to assess the correctness and completeness of the auditors' reports and will undertake relevant enforcement measures when deemed necessary.

33. **Under the Independent Financial Audit Law (2001), the chairman of the Managing Board of the ICPAB imposes sanctions for auditor's misconduct and violations, a duty that rested with the Minister of Finance under the Accountancy Law (1991).** These sanctions include being fined from 300 to 3,000 Bulgarian leva (approximately US$160 to US$1,600) or being barred from auditing for a period up to three years or being barred permanently. However, the absence of an effective quality review system has resulted in few sanctions being levied. The ICPAB has recently approved Rules for Quality Assurance of the Auditors' Work and adopted an external

[7] General-purpose financial statements are prepared based on the same accounting standards as for regulatory reporting.

quality control review program whereby all members of the ICPAB will be inspected every three years.

III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

34. **The IAS financial statements of five banks were reviewed and were generally of high quality.** The banks carry out straightforward banking and securities transactions resulting in relatively simple financial statements. Furthermore, as the banks do not have subsidiaries, there is no requirement for them to present consolidated financial statements. However, an area of possible conflict with IAS, but not national requirements, is in the calculation of loan loss provisions. There are also indications of several practical difficulties in applying IAS, in particular the determination of fair values of financial assets and financial liabilities (IAS 32, *Financial Instruments: Disclosure and Presentation*; and IAS 39) and the status of adjustments in prior years for the effects of hyperinflation (IAS 16, *Property, Plant and Equipment*; and IAS 29, *Financial Reporting in Hyperinflationary Economies*).

35. **Preparers, users, and auditors of financial statements referred to widespread practices that may hinder the transparency of financial statements and result in noncompliance with NAS and/or IAS.** First, there appears to be a conscientious effort to understate net income, which results from the relationship between NAS and taxation. This issue may well subsist after the adoption of IAS. Secondly, transfer pricing appears to be used as a means to distribute earnings rather than paying dividends thereby damaging the interests of minority shareholders.

36. **From 2003 (2005 for SMEs), the IAS legal entity net income will be used in the accounting and tax net income reconciliation.** There has been little training of the Tax Administration to allow the tax officers to understand the basis on which the accounting net income was determined under IAS.

37. **Representatives of audit firms referred to several practical difficulties in implementing current IAS in the particular circumstances of Bulgaria.** The most frequent problem is the pervasive influence of tax legislation on the choice and application of accounting requirements.[8] Another significant issue is the relative unimportance attached to consolidated financial statements. There is also a lack of understanding by management that accounting and reporting extend beyond the accounting department.[9] Finally, as highlighted in Section IIC, Professional Education and Training, there is a general lack of trained accountants in corporate Bulgaria who could prepare IAS financial statements.

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8 While this problem undoubtedly occurs in other countries, it has negative impact on the transparency of financial reporting.

9 In the case of a construction company using the percentage of completion method (IAS 11, *Construction Contracts*), project managers refused to provide estimates of the stage of completion of their contracts indicating that this was the duty of the accounting department.

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

38. **While many audit firms make strenuous effort to carry out audits in accordance with national standards based on ISA, there are claims that few shareholders, directors, and members of management understand the purpose of an audit, therefore making it difficult to obtain appropriate audit evidence.** While this problem undoubtedly occurs in other countries, including those with developed audit requirements and practice, it is understood that the extent of some problems is more widespread in Bulgaria than in other countries. With plans to conduct more workshops in the future, the State Securities and Exchange Commission has organized and conducted seminars on IAS implementation for the managers and employees of listed companies. Despite this effort, there is an obvious need for more education of investors, directors, and members of management that could be addressed under the follow-up on the ROSC Corporate Governance module. The banking sector could also play an instrumental role in requiring audited financial statements from borrowers, not as part of a box-ticking exercise that afford the banks no extra protection, but rather as a key element of their credit risk assessments. The banks may also develop an internal register of acceptable auditors based on prior experience and thereby foster the development of quality audits.

39. **There is also conflicting evidence about effectiveness of the quality control reviews carried out by the ICPAB.** At present, the quality control reviews are still in their infancy and have not yet had any significant impact on the quality of audits. The new leadership of the ICPAB has made implementation of quality control reviews one of its priorities.

40. **There is a Bulgarian translation of the International Standards of Audit but there is still no publication, and more guidelines for their implementation are needed.** Purely local firms and sole practitioners have increasing access to international ISA literature

V. PERCEPTIONS ON THE QUALITY OF FINANCIAL REPORTING

41. **Investors, lenders, and rating agencies generally differentiate between the larger banks audited by international audit firms and other Bulgarian companies.** They indicated that the audited (consolidated) financial statements of the larger banks are generally readily available and of adequate quality, with exceptions. They generally do not have a high opinion of the quality of audited financial statements issued by the balance of Bulgarian companies. Interviews and discussions with representatives of several institutional investors, lenders, and rating agencies revealed several areas of serious concerns about the quality of financial reporting in those companies, such as (a) related-party transactions, (b) hidden revenues, (c) transfer pricing, (d) lack of comparability between years, and (e) impairment of assets.

VI. POLICY RECOMMEDATIONS

42. The following policy recommendations were agreed between the World Bank staff members, the Ministry of Finance, and country stakeholders. It was also agreed that a detailed Country Action Plan would be developed and implemented on the basis of these policy recommendations. The Action Plan, developed by in-country stakeholders, will be implemented under the coordination of the Ministry of Finance and with assistance from international development partners. The policy recommendations are based on the new legislative framework and hence do not comment on the Accountancy Law (1991).

43. **Amend accounting and auditing laws and standards.** The Accountancy Law (2001) and the Independent Financial Audit (2001) should be amended and other measures taken to incorporate the following recommendations:

- Remove existing discrepancies and avoid future inconsistencies with IAS in the Accountancy Law (2001).
- Provide SMEs with a reporting framework more adapted to their size than IAS in the Accountancy Law (2001).
- Take maximum advantage of the accounting and auditing exemption in the EU Fourth Directive for SMEs when there is no public interest requirement for the preparation, publication, or audit of financial statements.
- 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 individual IAS that should link into IFRIC.

44. **Financial reporting and auditing of banks, insurance companies, and pension funds (collectively referred to as financial institutions).** The supervisory institutions and/or the related laws should strive to provide financial information, as needed. Where the Bulgarian National Bank and other regulators need additional (unpublished) information for prudential supervision purposes, this should be by way of topping-up IAS. This approach would make clear the distinction between prudential and general-purpose financial reporting. However, since the regulators would have a keen interest in ensuring that the base IAS financial statements are correct—since their reports would be built on that foundation—this would mobilize them to assist in the enforcement of shareholder- or stakeholder-oriented financial statements as well.

45. **Enforce publication and filing of legal entity and consolidated financial statements.** The law should be amended and enforcement mechanisms reviewed as follows:

- The Accountancy Law (2001) should conform the date of publication of legal entity and consolidated financial statements.

- The requirement of the Accountancy Law (2001) that "financial statements should be published in the form in which they were audited and with the auditor's report" should be strictly enforced. Publication of abridged financial statements (in newspapers and on websites, including that of the State Securities and Exchange Commission) should be avoided or authorized only if:
    - abridged financial statements are appropriately titled to identify the audited financial statements from which they have been derived, for example, "Summarized Financial Information Prepared from the Audited Financial Statements for the Year Ended December 31, 2002";
    - auditor's report accompanying the abridged financial statements is in accordance with ISA 800, *The Auditor's Report on Special Purpose Audit Engagements*, and which, among other things, includes the statement, "For a better understanding of the Company's financial position and the results of its operations for the period and of the scope of our audit, the summarized financial statements should be read in conjunction with the financial statements from which the summarized financial statements were derived and our audit report thereon;" and
    - audited financial statements are readily available to all interested parties.

  Article 49 of the EU Fourth Directive provides for similar caveats relating to the publication of abridged financial statements—though the wording is slightly different.
- 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.

46. **Strengthen oversight of accounting and auditing regulations.** While this review has found most legislative arrangements to be adequate subject to minor fine-tuning, a significant compliance gap has been noted. This calls for a strengthening of the oversight arrangements, including the following:

- The State Securities and Exchange Commission, the Bulgarian National Bank, and other regulators should review the IAS-based financial statements of all public securities issuers and take appropriate action against those companies and their auditors when the financial statements do not comply fully with IAS. The review should entail verifying the completeness of the financial statements and especially the notes, thereby assuring the coherence and reasonableness of financial statements. The Commission, the Bulgarian National Bank, and other regulators should also ensure that the published annual report includes the "financial statements in the form in which they were audited and with the auditor's report". For listed financial institutions the regulators should coordinate with the State Securities and Exchange Commission. This mechanism should be set out in the law.

- The ICPAB should implement a quality assurance system to ensure that auditors comply with applicable auditing and ethical standards, and independence requirements. The system should include quality reviews of audit firms and specific audit engagements based on an established schedule, so that (a) every audit firm or sole practitioner and (b) the audit working papers for every public company and financial institution would be subject to regular oversight (for example, every three years). The relevant regulators (the State Securities and Exchange Commission and the Bulgarian National Bank) should be authorized to participate in this mechanism and, on a systematic basis, receive a report detailing the conclusions of quality review assessments relating to the audits of the enterprises they supervise. Remedies should provide for sanctions, including injunctions, fines, temporary and permanent disbarment, and criminal liability.
- As the deficiencies of self-regulatory arrangements become clearer on the international scene, it appears that the current audit profession self-regulatory arrangement and power to impose sanctions should be balanced with an adequate oversight system, which is currently lacking. 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. In order to satisfy the public interest, both auditors and non-auditors should participate in the work of the oversight body.
- The aforementioned oversight body should, among other duties, take over the authority granted by the Independent Financial Audit Law (2001) to the chairman of the Managing Board of the ICPAB to impose sanctions for auditor's misconduct and violations. This authority should rest with a committee rather than with an individual. A minority of committee members may have a legal background to ensure that sanctions are levied with due process and fairness.

47. **Institute professional education and training.** In adopting IAS and ISA within a very short timeframe, Bulgaria has set challenging and demanding objectives for itself. This translates into a need for related education and training for auditors, tax administrators, and regulators. There is a myriad of IAS and ISA training being offered in Bulgaria, but there is a clear lack of a strategic plan both at the country level and within individual enterprises and institutions to ensure that this training meets the needs of the country and institutions. The strategic training plans should encompass some of the following areas:

- Develop an accounting curriculum at college and universities that meet the needs of corporate Bulgaria. While the accounting major curriculum would include IAS training, it would most probably also include more business administration and case studies to ensure that the graduates are better prepared to operate as accountants (rather than bookkeepers or tax compliance officers) in corporate Bulgaria.

- Assist corporate Bulgaria in assessing their training requirements arising from the introduction of IAS and conduct training that extends beyond the accounting department.
- Provide meaningful IAS theoretical and practical training to the State Securities and Exchange Commission and other regulators so they can enforce accounting standards.
- Provide IAS training to tax inspectors (there are approximately 1,500 inspectors, of which 200 work in the large taxpayers' office, which represent more than 70 percent of enterprise income tax revenues). As IAS net income will be the starting point of the accounting and tax reconciliation, tax inspectors should have a sound understanding of IAS.
- Organize additional IAS and ISA training, including practical training and coaching, for grandfathered auditors where recommended by the ICPAB quality assurance review.
- Review the professional education, examination, and traineeship arrangements to ensure that they are in line with internationally recognized accreditations. While the system appears to be adequate in theory, its implementation is heavily criticized and most members of international audit firms still require their staff to attend the Association of Chartered Certified Accountants (ACCA) professional scheme or an equivalent program. The ICPAB may assess whether partnering with ACCA (or some other suitable institute) with the aim of a joint scheme (as happens elsewhere) would be a meaningful solution to existing professional education challenges.

The strategic training plans should be further detailed in the Country Action Plan to be developed by in-country stakeholders. The extensive training programs should then be implemented under the coordination of the Ministry of Finance and with assistance from international development partners.