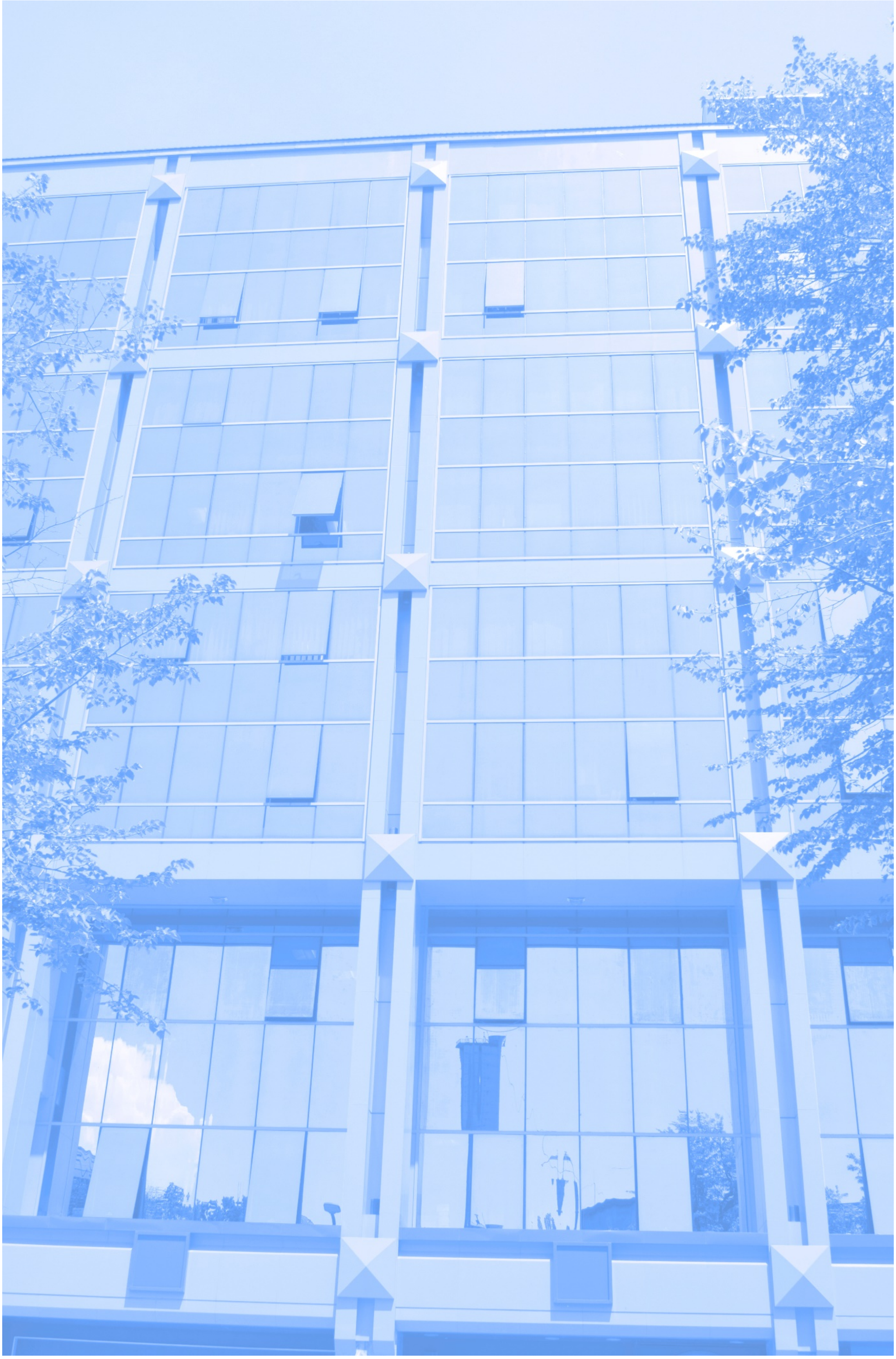
REPORT

on the Outcomes of the 2018 Financial Audit Engagements conducted by the Bulgarian National Audit Office



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1. Goals of Financial Auditing

In 2018, the Bulgarian National Audit Office (BNAO) conducted audits of the 2017 annual financial statements of public sector entities. Financial auditing is an expression of an independent audit opinion with a reasonable degree of assurance on whether the annual financial statements of a public sector entity are prepared, in all material respects, in accordance with the applicable financial reporting framework. This audit opinion helps increase the users' **confidence** in the information disclosed in the financial statements. The internationally accepted auditing standards require from an auditor to express opinion only when they have obtained **reasonable assurance** about whether the financial statements as a whole are free from material misstatements due to fraud or error. There are unmodified, qualified and adverse audit opinions. **The unmodified audit opinion** shows that the **audited financial statements are free from material misstatements** and that in the notes to them there are no omissions of non-financial information of relevance to the users. The financial statements on which the BNAO has expressed an unmodified opinion give a true and fair view of the financial position, financial performance and cash flows of the public sector entity. The BNAO expresses a **qualified opinion** when the audited financial statements **contain material misstatements** or omissions of important non-financial information, whose **effect is confined.**

Financial statements on which the BNAO has expressed a qualified opinion **give a true and fair view** of the financial position, financial performance and cash flows of the public sector entity, **except for the effect of the misstatements or omissions. An adverse opinion** is issued when **the audited financial statements contain material misstatements** or omissions of important non-financial information, whose **effect is pervasive**. Financial statements on which the BNAO has issued an adverse opinion **do not give a true and fair view** of the financial position, financial performance and cash flows of the public sector entity. In exceptional cases, when the **circumstances[1] prevent the auditor from conducting the necessary audit procedures,** the BNAO issues a **disclaimer of opinion.** It is impossible to conclude whether the financial statements on which the BNAO has issued a disclaimer of opinion give a true and fair view of the financial position, financial performance and cash flows of the respective public sector entity.

This brief outline of the essential characteristics of financial auditing points to the fact that the benefits of financial auditing are conditioned on two factors. First, conducting the audit in line with the internationally accepted standards of auditing and second, the

[1] For example, when the audited entity's management refuses or is unable to provide to the auditors specific information due to reasons outside of its control.

application of a public sector financial reporting framework that contributes to improving the quality and transparency of financial reporting by providing information regarding the management's decision-making processes.

2. Applying the Internationally Accepted Standards of Auditing

The BNAO adheres the principles and procedures set out in International Standards on Auditing (ISA) and the International Standards of Supreme Audit Institutions (ISSAI). The BNAO's auditing methodology is outlined in the *Manual on Implementing the Internationally Accepted Auditing Standards and on the Audit Function of the Bulgarian National Audit Office.* This Manual is updated regularly based on analysis of its practical implementation and in line with the development of the auditing standards. The specialized *Audit Activity Development Directorate* supports the auditing directorates in implementing the internationally accepted standards of auditing. A significant part of the requirements in the auditing standards (included also in the Manual) concerns quality control through monitoring the implementation of the ISSAI based on policies and procedures.

3. 2017 Financial Reporting Framework

The financial reporting framework in Bulgaria consists mainly of the following:

- Law on Public Finances;
- Accountancy Act;
- Instructions No 20/2004 (issued by the Ministry of Finance, Treasury Directorate) on adaptation of the National Accounting Standards;
- Instructions No 14/2013 (issued by the Ministry of Finance, Treasury Directorate) on the application of the Public Sector Chart of Accounts and additional Guidance No 08/2014 on reporting of specific operations, assets and liabilities in the context of applying the Public Sector Chart of Accounts;
- 2017 Uniform Budget Classification approved by the Minister of Finance for cash-basis reporting of economic operations.

The public sector financial reporting framework in Bulgaria is regulated mainly through Chapter 15 "Public Sector Accounting" of the Law on Public Finances. The Minister of Finance endorses **Accounting Standards and Chart of Accounts and issues guidance to the public**

sector entities in compliance with:

- The EU requirements on public sector financial reporting, statistics and budgeting;
- Accounting framework, principles and concepts of the Methodological Guidance for Government Finance Statistics issued by the International Monetary Fund;
- The International Public Sector Accounting Standards issued by the International Federation of Accountants;
- The requirements in the Bulgarian legislation regarding budgeting, accounting and implementation of the consolidated fiscal program, governance and control of spending in the public sector entities[2].

In 2017, Instructions No 20/14.12.2004 containing guidance by the Minister of Finance on the application of the National Accounting Standards by public sector entities continued to be in effect[3]**.** Over the years, more than 100 additional guidance documents issued by the Treasury Directorate of the Ministry of Finance have been added to this fundamental guidance document for public sector financial reporting. The additional instructions regulate various financial reporting issues – Annual Uniform Budget Classification; Chart of Accounts; guidance on the monthly, quarterly and annual financial statements; requirements for disclosure; and, last but not least, amendments to the requirements for financial reporting of assets, liabilities, revenue and expense[4].

In 2005, the Minister of Finance issued Guidance[5] **that the provisions of Treasury instructions No 20/2004 would continue to apply for public sector entities, *regardless of the repeal of the National Accounting Standards (NAS)*[6].** NAS ceased to apply only to non-public sector entities. However, § 41, paragraph 3 of the 2005 *Law on the Government Budget of the Republic of Bulgaria* and article 5a, paragraph 3 of the *Accountancy Act*[7] do not require automatic transformation or discontinuation of the NAS for public sector entities, unless a statutory guidance to that effect is issued by the Ministry of Finance.

According to the general provisions of the NAS (still in effect for public sector entities) accounting should be based on the concept of financial capital maintenance. **This is in contradiction to the wide-spread perception[8] that the main purpose of most public sector entities is rendering of public services rather than generating profit and return for the sake**

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[2] Law on Public Finances, art.164

[3] Council of Ministers Decree No 65 from 1998, SG issue 36 from 31 March 1998 effective as of 01 January 1998, amended SG 51 from 1999; edited SG 54 from 1999; amended SG 82 from 1999, SG 3 from 2000, SG 8 and 12 from 2001, SG 22 and 97 from 2002, repealed by Council of Ministers Decree No 46 from 21 March 2005 effective as of 01 January 2005.

[4] Examples of instructions introducing amendments to the financial reporting framework:

- Public Sector Chart of Accounts from 01 January 2015.
- Guidelines on the reporting of economic operations contained in letter 14 dated 30 December 2013 of the Treasury Directorate in relation to the application of the Public Sector Chart of Accounts.
- Additional Guidance on the reporting of specific operations, assets and liabilities in applying the Public Sector Chart of Accounts published in letter No 08 from 16 September 2014 by the Treasury Directorate, MF.
- Guidance on accounting of EU funds by the central government and municipalities contained in Instructions 06 and 07 from 04 April 2008 by the Treasury Directorate, MF; letter No 2 from 27 January 2015 by the Municipal Finances Directorate and No 01 from 26 January 2015 by the Treasury Directorate, as well as letter No 03 from 31 March 2016 of the Treasury Directorate, MF.
- Guidance on Depreciation of Non-current Non-financial Assets in Public Sector Entities contained in letter No 05 from 30 September 2016 of the Treasury Directorate, MF.

[5] Treasury Instructions 08 from 28.06.2005, item 30

[6] Council of Ministers Decree No 46 from 21.03.2005 (SG issue 30 from 2005), Final Provisions § 1

[7] Repealed SG issue 95 from 8 December 2015.

[8] International Public Sector Accounting Standards, Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities, item 2

of shareholders. The above-mentioned guidelines help adapt the national accounting standards to the public sector needs but, in essence, the NAS remain tailored for the private sector.

The 2001 *Accountancy Act*[9] sets out a requirement that public sector entities should prepare and present their annual financial statements based on public sector accounting standards designed in line with the International Public Sector Accounting Standards (IPSAS). Following the 2013 amendments to the *Accountancy Act*[10] the same requirement was set out in article 164 of the *Law on Public Finances* in effect as of 01 January 2014. **Nonetheless, to this date Bulgaria has not yet introduced such public sector accounting standards.**

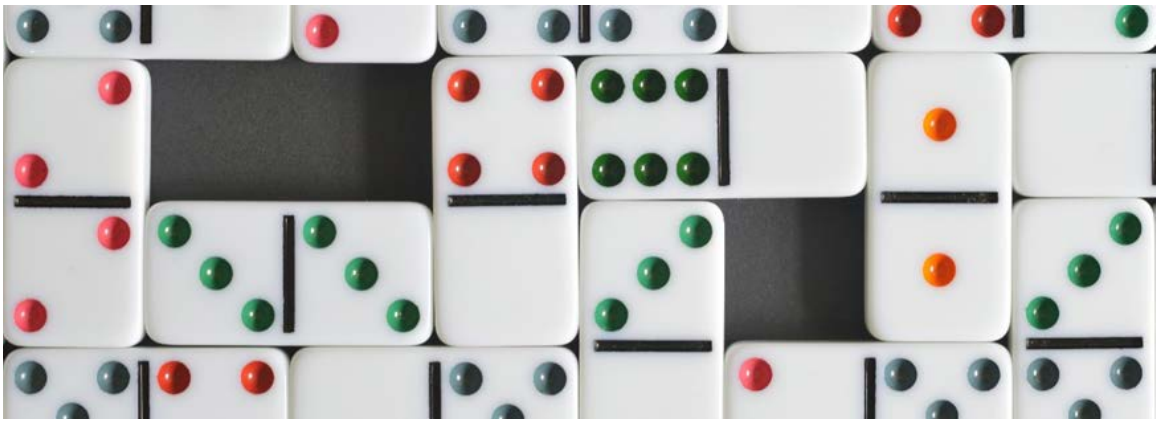
The above-mentioned circumstances pose a number of difficulties and challenges for the officials responsible for preparing the financial statements of public sector entities, as well as for the financial auditors. **The Minister of Finance guidance introduces requirements related to specific provisions and concepts in the repealed NAS, which specific provisions and concepts have been revoked or amended in subsequent versions of the NAS.** An example is the measurement at and after recognition of assets. According to the MF guidance[11], the measurement of non-current tangible assets after recognition should be done in line with the provisions of item 7.1 (recommended approach – cost model) and 7.2 (possible alternative approach – revaluation model) of NAS 16 (repealed). The provisions of item 7.2 of NAS 16 were repealed[12], however, MF has not issued methodological guidance regarding the accountancy of public sector entities in such cases. There are other similar examples, such as classification of assets in the accounts of the Public Sector Chart of Accounts; the application of cash basis of accounting for the economic events, incl. capital expenditure; specific definitions in relation to previously issued guidance (e.g. for concepts such as “adjoining land/ terrain”, infrastructure, etc.).

Some MF guidelines contain requirements that are not perfectly in line with the principles set out in the Accountancy Act[13]. Examples are item 18.1 of Treasury Instructions No 20/2004 and item 21 of Treasury Instructions No 10/2009 requiring that the **revenue from taxes, customs duties and other taxation proceeds be recognized on cash basis. As a result, such revenues and the relevant receivables cannot be recognized on accrual basis but should rather be reported once the cash flows have been paid in.** This is contradictory to the **accrual principle[14] according to which the effect of transactions and other events should be recognized at the moment of their occurrence, regardless of the time when the cash payments or their equivalent are received, and that they should be disclosed in the financial statements for the period when they occurred. Reporting taxes on accrual basis is a challenge that has been identified at EU level in a number of analytical documents and joint action has been planned[15].**

Another example is item 36.1 of Treasury Instructions No 20/2004 requiring a review for impairment of the non-current non-financial assets **once every two years[16].** This in effect means

[9] article 23, paragraph 4 of the Accountancy Act (repealed) in effect from 01.01.2002 through 31.12.2004; article 5a, paragraph 3 of the Accountancy Act (repealed) in effect from 01.01.2005 through 31.12.2013.
[10] Amended SG issue15 from 15 February 2013
[11] Treasury Instructions No 20/2004, item 16.23
[12] SG issue 86 from 2007 in effect as of 01.01.2008.
[13] Article 26, paragraph 1 of the Accountancy Act in effect as of 01 January 2016.
[14] Article 26, paragraph 1, item 4 of the Accountancy Act in effect as of 01 January 2016.
[15] EUROSTAT, Ernst and Young, Position paper on accounting treatment of the EC WG on EPSAS, 30 June 2016; and EUROSTAT, Ernst and Young – Overview and comparative analysis of the public sector accounting and audit practices in the 27 MS, 19.12.2012.
[16] Item 86 of Treasury Instructions No7/2017 requires testing for impairment at least once every three years as of 2018.

that public sector entities **are not required to perform annual tests for impairment, i.e. to analyze at the end of each reporting period[17] whether there are indications of impairment of the value of any given item and if so to calculate the recoverable amount for the assets. This leads to non-compliance with the prudence principle[18] that requires estimation and disclosure of the possible risks and expected possible losses in the accounting treatment of economic operations to report the actual financial results.**



As of 01 January 2017, there has been a new element in the public sector accounting, namely a requirement for **depreciation of non-current non-financial assets** regulated in Treasury Instructions No 05/2016. In the process of auditing the 2017 annual financial statements, the National Audit Office identified[19] various **different practices of interpretation and application of these rules when the individual depreciation plan of an asset needs to be changed. Therefore, BNAO put forward the following recommendations to the Ministry of Finance:**

- Clarify the definition of "depreciable amount" set out in item 9, g of Treasury Instructions No 05/2016 by adding a sentence to the following effect: *„In case of changes in the depreciation schedule, depreciable amount should be calculated as the difference between the asset's cost, its residual value and the accumulated depreciation."* or *„In case of changes to the depreciation schedule, depreciable amount should be calculated as the difference between the asset's carrying amount and its residual value.".* **The current definition of *depreciable amount* is not clear enough, because it fails to take into consideration the depreciation accumulated to the moment the asset's depreciation schedule was changed, and this is a precondition for errors.**
- Put down a clear requirement that in case of changes in the depreciation schedule parameters, the depreciation rate should be recalculated so as to reflect the useful life of the asset, i.e. the recalculation should be performed for the remaining and not for the total useful life of the asset, since this is not an initial depreciation, but a continuation of a process of depreciation that has started previously;
- Specify more precisely the approach to be followed in case of changes in the depreciation schedule resulting from revaluations and impairment; applying a new depreciation method; revising the expiry date or giving a new residual value; capitalization of subsequent costs and other events, including specifying the moment in time at which the depreciation schedule

[17] This requirement is set out in paragraph 26 of **IPSAS 21** *Impairment of non-cash generating assets* and paragraph 22 of **IPSAS 26** *Impairment of Cash-Generating Assets*

[18] Article 26, paragraph 1, item 3 of the Accountancy Act in effect as of 01 January 2016.

[19] The BNAO informed the Minister of Finance of the identified weaknesses in the regulation of depreciation in a letter No 04-50-01 dated 24 August 2018.

should be changed (e.g. month following the month of change; quarter; following reporting period).

4. Acceptability of the Public Sector Financial Reporting Framework

ISSAI 1210 - *Agreeing the Terms of Audit Engagements* outlines requirements and guidance relating to the auditor's judgment regarding the **acceptability of the applicable financial reporting framework**. The BNAO takes into consideration factors such as the nature of public sector entities, the purpose and nature of the financial statements, legal framework, etc. Public sector entities in Bulgaria publish **general purpose financial statements and therefore, these statements should satisfy the general information needs of a broad range of users**. The quality of information in the general purpose financial statements of public sector entities should be assessed based on the requirements of the **only set of internationally recognized accounting standards[20] - the International Public Sector Accounting Standards** of the International Federation of Accountants. The qualitative characteristics that contribute to the usefulness of information and ensure the attainment of financial reporting goals are as follows[21]:

- **Relevance** – information should help corroborate or reject former or current expectations of users and, to a certain extent, offer an estimate of the entity's capabilities to continue rendering public services, attaining its goals, and having access to the necessary resources.

- **Faithful representation –** it is attained through a complete neutral and free from material misstatements description of the economic and other events. Omission of information may mislead the users. Neutrality is important because the lack of bias in information disclosure prevents predetermined outcomes.

- **Understandability –** information should be presented in a way that corresponds to the needs and takes into consideration the level of competence of the users. It is generally assumed that users have a reasonable understanding and knowledge of the

[20] Commission Report to the Council and the European Parliament on the application of harmonized public sector accounting standards in the MS, COM(2013) 114, page 3

[21] International Public Sector Accounting Standards, Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities; Chapter 3. Qualitative Characteristics

functions of the respective public sector entity and the environment in which it operates, and that they are capable of understanding and analyzing information contained in financial statements.

- **Timeliness** – it should be kept in mind that information may cease to be useful before it is provided to the users.

- **Comparability** – the information should enable the identification of similarities and differences between operations, processes, performance of public sector entities. IPSAS stress that comparability is not a characteristic feature of separate information units, but rather relates to the correlation between these information units. Comparability should not be confused with consistency meaning application of the same accounting principles over time or across the public sector. Comparable does not mean identical, i.e. making different aspects look the same.

- **Verifiability** – enabling independent observers with different knowledge to reach a common agreement that the information presents the entity's operations and position without any significant discrepancies and that the accounting methods for recognition, estimation or disclosure are applied without any errors or misrepresentation.

The ability to satisfy the strict requirements of the internationally recognized financial reporting framework is at risk in Bulgaria due to all aspects presented above:

- Public sector financial reporting requirements are developed based on accounting standards intended for the private sector;
- Lack of consolidated financial reporting framework and availability of numerous general and specific accounting guidelines.

5. Future Development of the Public Sector Financial Reporting Framework

Bulgaria should take into consideration the global and European trends relating to the application of the International Public Sector Accounting Standards and the attempts at introducing European Public Sector Accounting Standards (EPSAS)[22]. The European Court of Auditors monitors this initiative of the European Commission (supported strongly by EUROSTAT) and keeps the members of the Contact Committee (the liaison structure of the ECA and the SAIs of the member states) informed of the EPSAS project development and the related discussions.

Hypothetically, the BNAO **may start applying the criteria laid down in the International Public Sector Accounting Standards** in issuing its audit opinions**.** This will ensure compliance with the International Standards on Auditing[23] in cases of discrepancies between the financial reporting framework and the sources of guidance for its implementation or conflicting positions among the sources covering the financial reporting framework, by **giving priority to the most authoritative source.**

[22] Report by the European Commission to the Council and the Parliament on the introduction of harmonized public sector accounting standards in the member states, COM (2013) 114, page 3

[23] ISA 200 - Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing, paragraph A5

We recommend that the **financial reporting framework be reviewed** launching as soon as possible preparation for the introduction of the **International Public Sector Accounting Standards** (in line with the Law on Public Finances) or of the **European Public Sector Accounting Standards.**

Having regard to the development of the EPSAS project and its potential positive impact over the public sector financial reporting, the BNAO adopted[24] the following position in principle regarding the EPSAS:

1. The BNAO supports **the adoption of full accrual basis of accounting in the public sector.** This will ensure a fundament for adequate performance measurement and planning of public sector operations.
2. The BNAO supports the **adoption of a consolidated public sector financial reporting framework** to replace the current framework that consists of numerous general and specific guidelines for financial reporting.
3. The BNAO **supports the initiative for developing and introducing EPSAS** that will contribute to improving the quality of public sector financial reporting and ensure better financial management of the public resources and debt.
4. The BNAO **will support the efforts of the Ministry of Finance to modernize public sector accounting** and will continue to offer objective positions on the development of the financial reporting.
5. The BNAO will **monitor the development of the EPSAS project** taking into consideration the challenges relating to the transformation of the public sector financial reporting framework.
6. The BNAO will take active participation in forums and events on the topic of public sector financial reporting.

6. Audits of the 2017 Annual Financial Statements. Outcomes

In 2018 the BNAO reported on a total of 252 audits of the 2017 annual financial statements of public sector entities. A prevalent majority of 95 % of all reports[25] contain unmodified opinion *(see Fig. 1).* This is due to the fact that many of the **misstatements identified by the auditors were adjusted** during the course of the financial audits. The adjustments were introduced to make sure that the financial statements **give a true and fair view of the financial position, financial performance and cash flows** of the public sector entities and therefore **can serve as a reliable basis for decision-making at institutional, regional and national level.** The number of unmodified opinions is an indication of the **level of compliance** with the applicable financial reporting framework but not of the **quality of public sector accounting; the latter being a function of the nature of the financial reporting framework.**

Figure 1

[24] Decision No 166 from 15 June 2017.

[25] Compared to other Supreme Audit Institutions in EU, the BNAO has issued a relatively high number of unmodified audit opinions. According to a study conducted by the SAI of the Czech Republic by type of modification, the relative share of unmodified audit opinions on the financial statements of the central government entities is as follows: Croatia – 25 %, Finland – 61 %, Lithuania – 64 %, France – 77 %, Cyprus – 80 %, Latvia – 85 %, Portugal – 93 %, Sweden – 94 %.

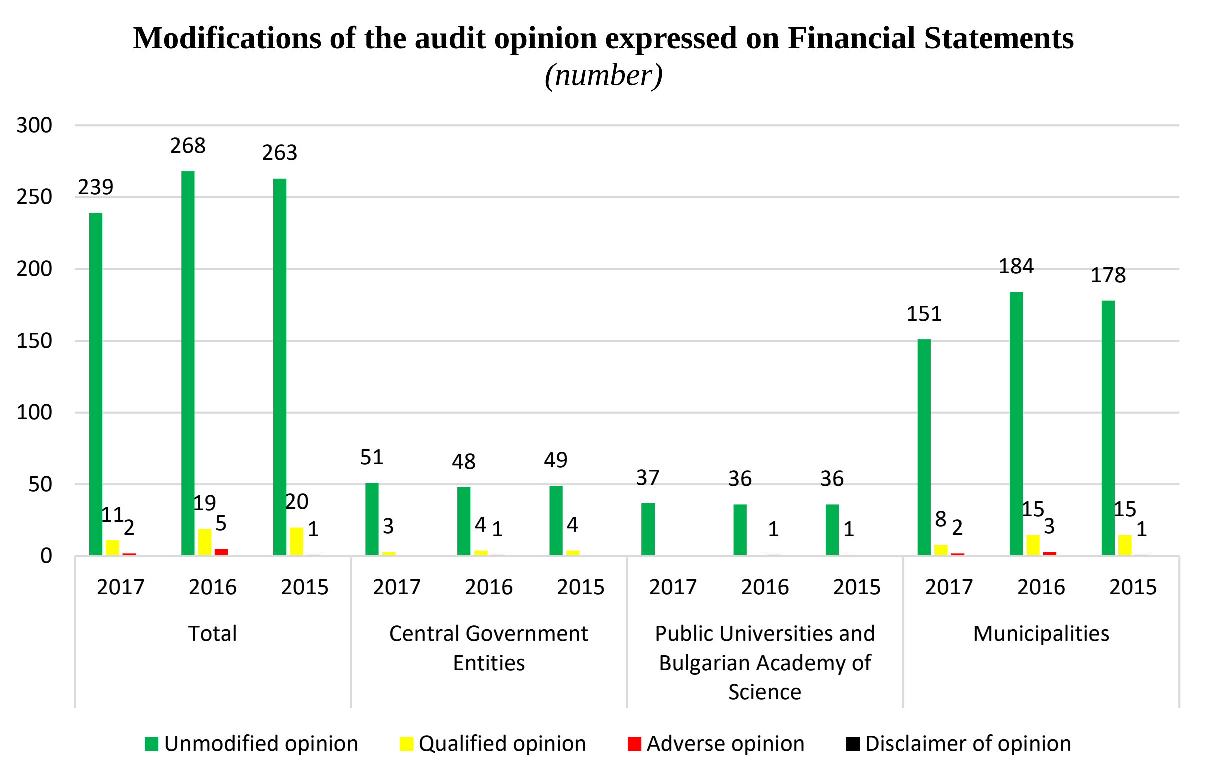
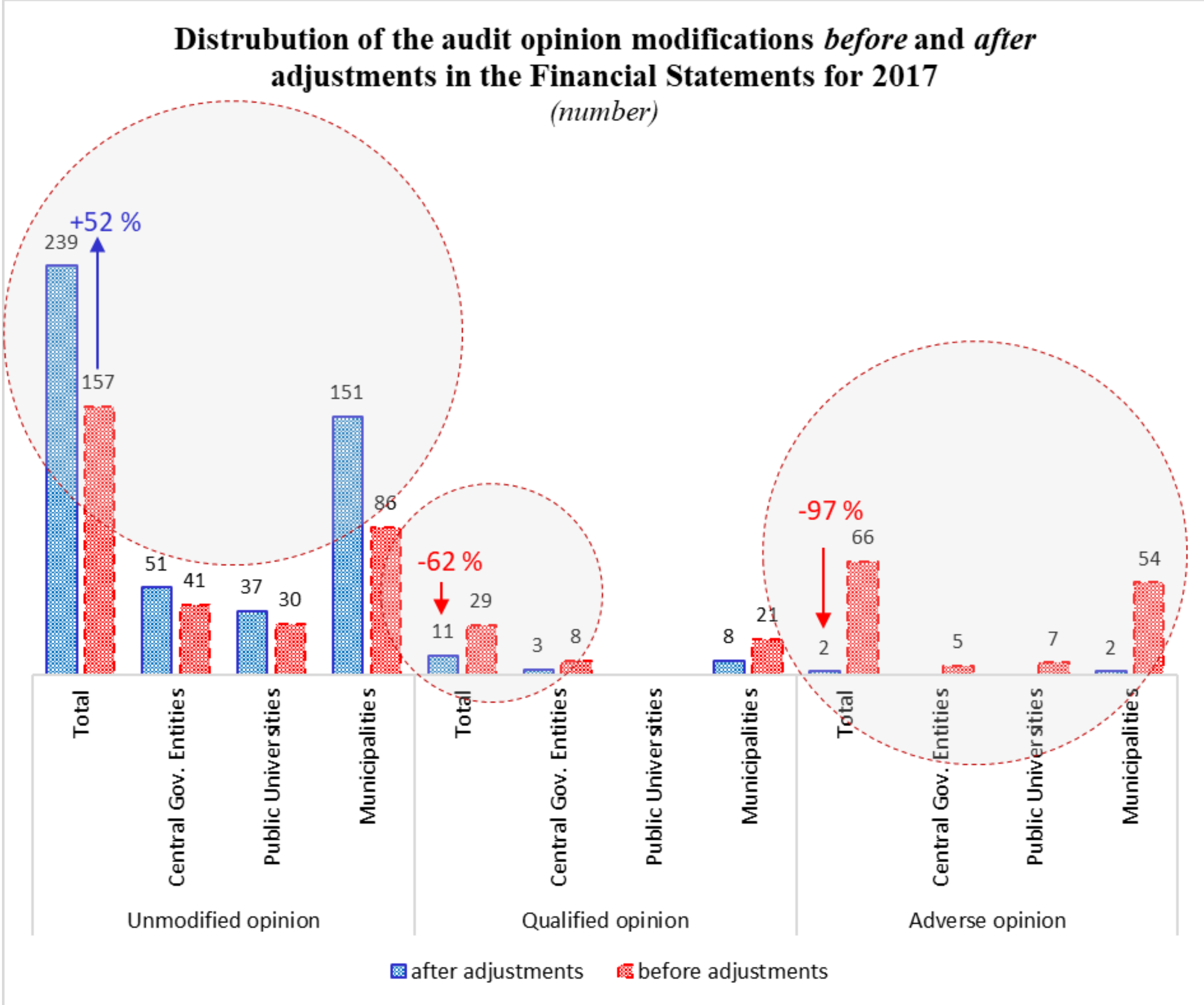


Fig. 2 shows the **positive impact of the adjustments**[26] on the reliability of information presented in the annual financial statements, illustrated through the number of modifications of the auditors' opinion in 2017. If adjustments had not been made, the BNAO would have issued an **adverse opinion** on the financial statements of 66 public sector entities and a **qualified opinion** on the financial statements of 29 entities. **As a result of the adjustments introduced in the course of the audits, the adverse opinions were reduced by 97 %, and the qualified opinions – by 62 %, whilst the number of unmodified opinions grew by 52 %.** In other words, the adjustments of the misstatements identified by the BNAO resulted in an increase in the number of financial statements giving a **true and fair view of the financial position, financial performance and cash flows of the public sector entities.** The most significant impact was observed in the case of municipalities where the unmodified opinions grew by 65 or 76 %.

[26] The number of modified opinions before adjustments is calculated based on the assumption that modifications are only conditioned on the scale of identified misstatements relevant to the level of materiality set for the financial statements. This approach has several important limitations: first, it does not take into consideration the possible different materiality levels for classes of transactions; second, it fails to account for misstatements material by nature; and third, it precludes the calculation of the potential number of disclaimers of opinion. Each of these factors alone provides additional grounds for opinion modification. Therefore, if their effect is taken into consideration, the number of modifications would grow. Consequently, in analyzing the effect of adjustments, one should take into consideration the fact that the above situation describes the best-case scenario.

Figure 2



6.1. Systemic Weaknesses Identified during the Financial Audits of Central Government Entities and Public Universities

The following groups of errors and irregularities were identified recurrently and were not adjusted:

- Inaccurate depreciation of non-current non-financial assets as a result of incorrectly defined useful life (not taking into consideration the year of acquisition, the physical wear and tear, and obsolescence) and failure to define the residual value. This affects both the depreciation expense and the carrying amount of the non-current non-financial assets.
- Failure to report correctly the changes in the share public sector entities' investments in the equity of commercial companies (also identified in the audits of the 2016 annual financial statements). This leads to misrepresentation in the annual financial statements of investments in equity and related revenues.
- Misstated commitments and provisions (also identified during the 2015 and 2016 financial statements audits) that usually result in underestimated expenses and balance sheet and off-balance sheet liabilities.

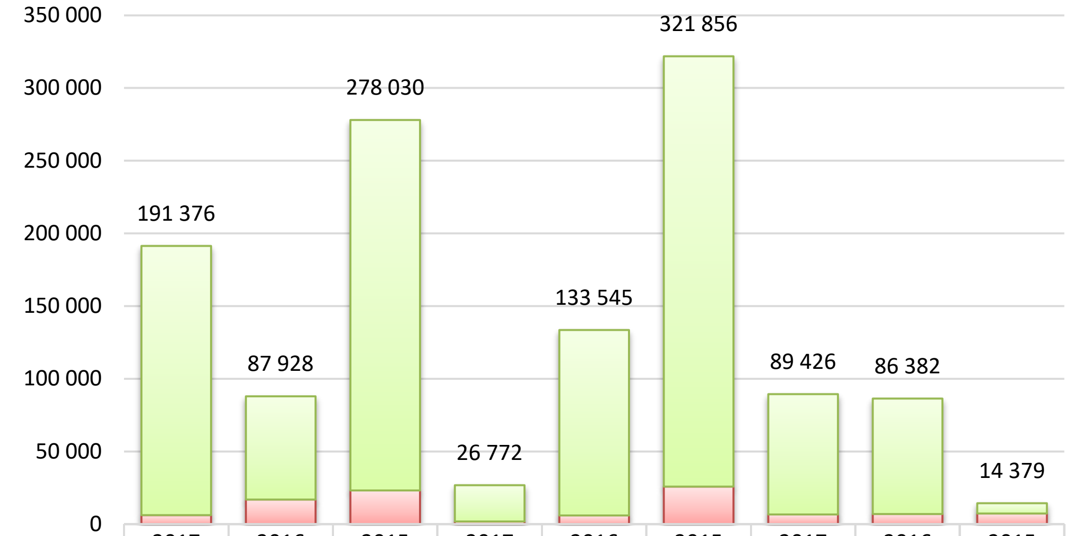
- Incorrect classification of assets, liabilities, revenues, expenses and transfers in the Public Sector Chart of Accounts and the Uniform Budget Classification (also identified during the 2015 and 2016 financial statements audits) resulting in misrepresentations in the balance sheet, income statement and budget execution statement.

Part of the errors and irregularities in the financial statements of ministries, agencies, other central government entities and universities were **adjusted** in the course of the audits:

- ✓ Adjustment of depreciation expense to ensure fair representation of the carrying amount of depreciable assets.
- ✓ Recognition of non-disclosed assets, liabilities, revenues and expenses (also adjusted during the 2015 and 2016 audits). These adjustments ensured fair representation and full disclosure in the financial statements.
- ✓ Writing off receivables already collected and debt already paid. This helps eliminate the overstatements of assets and liabilities of public sector entities.
- ✓ Recognition of overhauls cost in the carrying amount of assets to avoid overstatement of costs for current repairs and understatement of the carrying amount of assets and depreciation expense.
- ✓ Adjusting the classification of assets, liabilities, revenues, expenses and transfers in the Public Sector Chart of Accounts and the Uniform Budget Classification (also adjusted in the 2015 and 2016 financial statements audits), thus ensuring adequate disclosures in the balance sheet, income statement and budget execution statement.

Figure 1

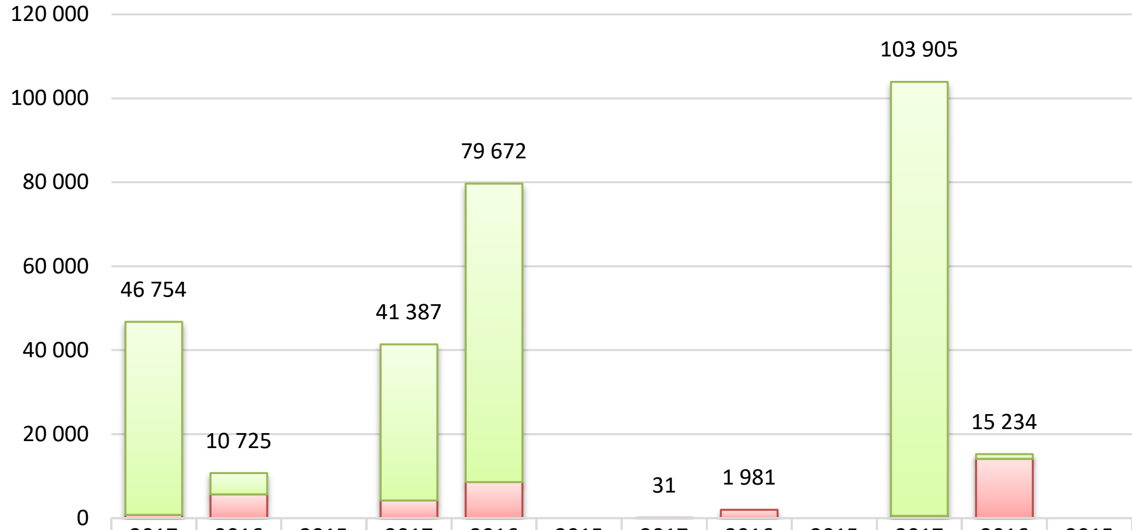
Adjusted and Non-Adjusted Misstatements in the Balance Sheets of Central Government Entities and Public Universities
(in thousands of euro)



	2017	2016	2015	2017	2016	2015	2017	2016	2015
	Assets			Liabilities			Contingent Assets and Liabilities		
Adjusted	185 192	71 029	254 865	24 955	127 586	296 043	82 778	79 435	7 081
Non-Adjusted	6 183	16 900	23 165	1 817	5 960	25 813	6 649	6 947	7 298
Total	191 376	87 928	278 030	26 772	133 545	321 856	89 426	86 382	14 379

Figure 2

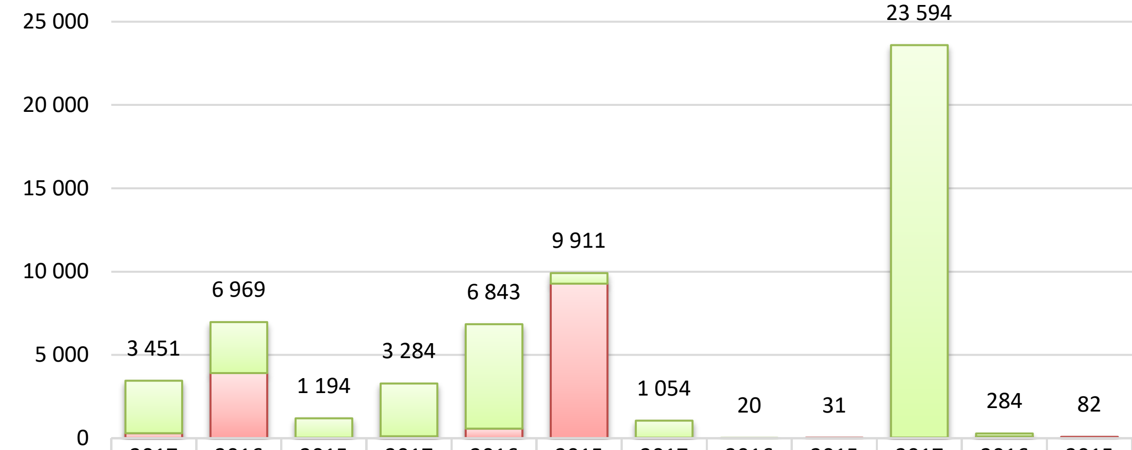
Adjusted and Non-Adjusted Misstatements in the Income Statements of Central Government Entities and Public Universities
(in thousands of euro)



	Revenues			Expenses			Transfers			Revaluation and Other Events		
	2017	2016	2015	2017	2016	2015	2017	2016	2015	2017	2016	2015
Adjusted	45 969	5 059		37 183	71 088		0	0		103 360	1 105	
Non-Adjusted	785	5 666		4 204	8 584		31	1 981		545	14 129	
Total	46 754	10 725		41 387	79 672		31	1 981		103 905	15 234	

Figure 3

Adjusted and Non-Adjusted Misstatements in the Budget Execution Statements of Central Government Entities and Public Universities
(in thousands of euro)



	Revenues			Expenses			Subsidies and Transfers			Operations with Financial Assets and Liabilities		
	2017	2016	2015	2017	2016	2015	2017	2016	2015	2017	2016	2015
Adjusted	3 151	3 060	1 165	3 167	6 269	635	1 023	20	0	23 553	172	0
Non-Adjusted	300	3 909	29	116	574	9 276	31	0	31	41	112	82
Total	3 451	6 969	1 194	3 284	6 843	9 911	1 054	20	31	23 594	284	82

6.2. Systemic Weaknesses Identified during the Financial Audits of Municipalities

The following recurring groups of errors and irregularities have been identified in the financial statements and have not been adjusted:

- Incorrect depreciation of non-current non-financial assets resulting from the inadequate calculations of their useful life (not taking into consideration the year of acquisition, the physical wear and tear, and obsolescence) and failure to calculate the assets' residual value. This affects both depreciation expenses and carrying amount of non-current non-financial assets.
- Incorrect classification of assets, liabilities, revenues, expenses and transfers in the Public Sector Chart of Accounts and the Uniform Budget Classification (also identified during the audits of 2015 and 2016 financial statements), which results in misrepresentations in the balance sheet, income statement and budget execution statement.
- Infrastructure self-construction costs are expensed instead of being recognized in the cost of an item of infrastructure (also identified during the audits of 2015 and 2016 financial statements), resulting in understatement of these assets in the balance sheet, understatement of the depreciation expense and overstatement of costs carried under the heading *Other Accounts and Activities*.
- Misstatements of municipal investments in the equity of commercial companies and understating or overstating the changes in the share of the investments (also identified during the audits of the 2015 and 2016 financial statements) resulting in unfair representation of such investments and the related revenue.
- Failure to adequately report revenues and expenses in corrective accounts at year-end, resulting in misstatements of revenues and expenses for the reporting period.

Without modifying the audit opinion, emphasis of matter was raised in the case of some municipalities that used short-term interest-free loans out of the Third-party Funds accounts in violation of the legal framework[27].

During the course of audits of the financial statements, some errors and irregularities at municipal level were **adjusted**:

- ✓ Adjustments of depreciation expense to achieve fair representation of the carrying amount of depreciable assets.
- ✓ Adequate disclosure of the changes in the share of municipal investments in commercial companies (also adjusted in the course of audits of the 2015 and 2016 financial statements) to achieve fair representation of the investments and the related revenue.
- ✓ Disclosure of commitments (taken and implemented) under contracts, bank guarantees, promissory note and other off-balance sheet assets and liabilities (also adjusted in the course of audits of the 2015 and 2016 financial statements). This ensures fair representation by offering full disclosure in the financial statements of the off-balance sheet assets and liabilities.

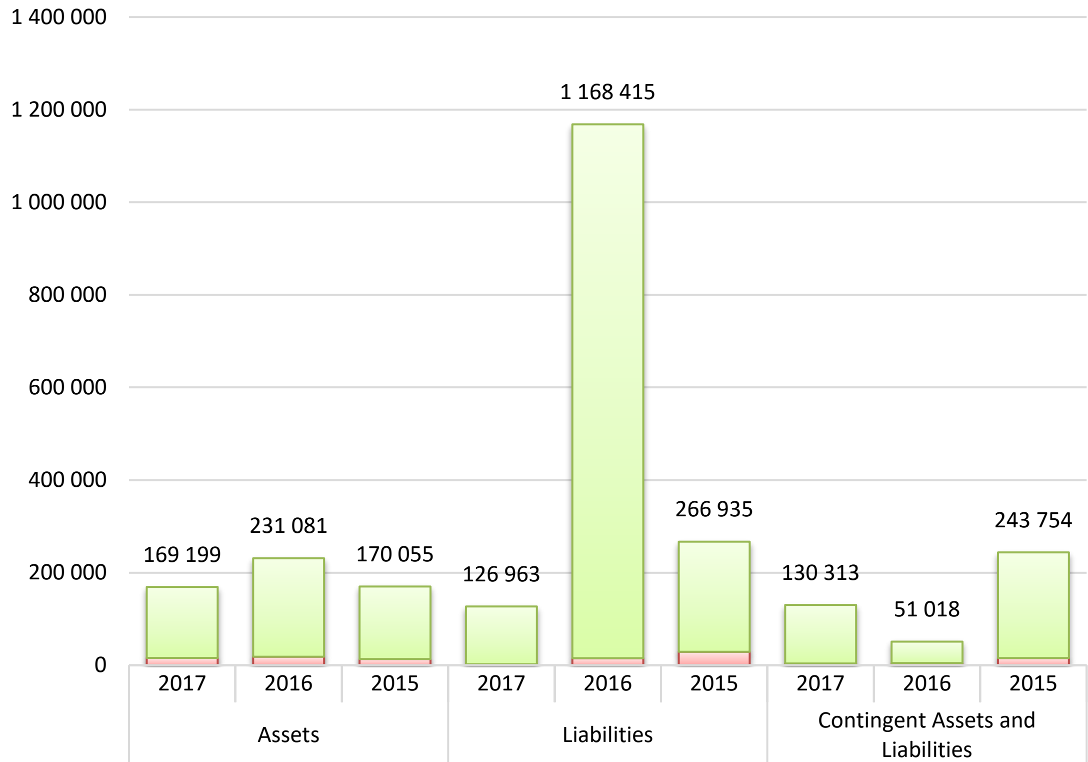
[27] Art. 147 of the Law on Public Finances prohibits the use of Third-Party Funds accounts to perform or report any activities other than the administration of third party funds and enforcement or asset recovery actions taken by the respective government authorities and the subsequent asset management and allocation in line with the applicable legislation.

✓ Recognition of non-disclosed assets, liabilities, revenues and expenses (also adjusted in the course of audits of the 2015 and 2016 financial statements). These adjustments ensure fair representation and complete disclosure in the financial statements.

✓ Correcting the classification of assets, liabilities, revenues, expenses and transfers in the Public Sector Chart of Accounts and the Uniform Budget Classification (also adjusted in the course of audits of the 2015 and 2016 financial statements), resulting in correct representation in the balance sheet, income statement and the budget execution statement.

Figure 4

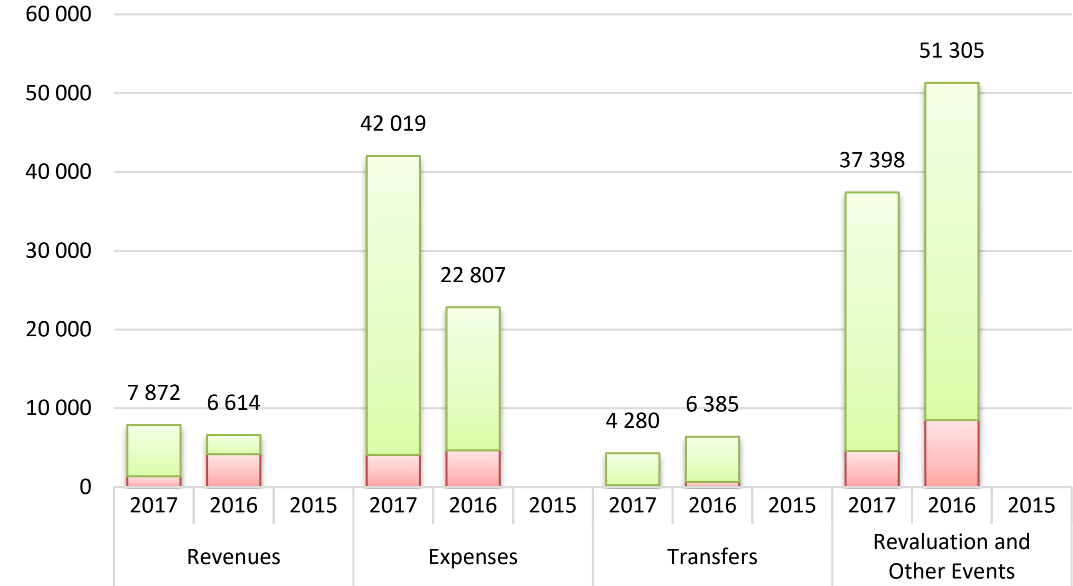
Adjusted and Non-Adjusted Misstatements in the Balance Sheets of Municipalities
(in thousands of euro)



	Assets 2017	Assets 2016	Assets 2015	Liabilities 2017	Liabilities 2016	Liabilities 2015	Contingent Assets and Liabilities 2017	Contingent Assets and Liabilities 2016	Contingent Assets and Liabilities 2015
Adjusted	153 362	212 633	156 535	124 700	1 153 042	237 798	126 447	46 245	228 101
Non-Adjusted	15 836	18 448	13 520	2 263	15 373	29 138	3 866	4 773	15 653
Total	169 199	231 081	170 055	126 963	1 168 415	266 935	130 313	51 018	243 754

Figure 5

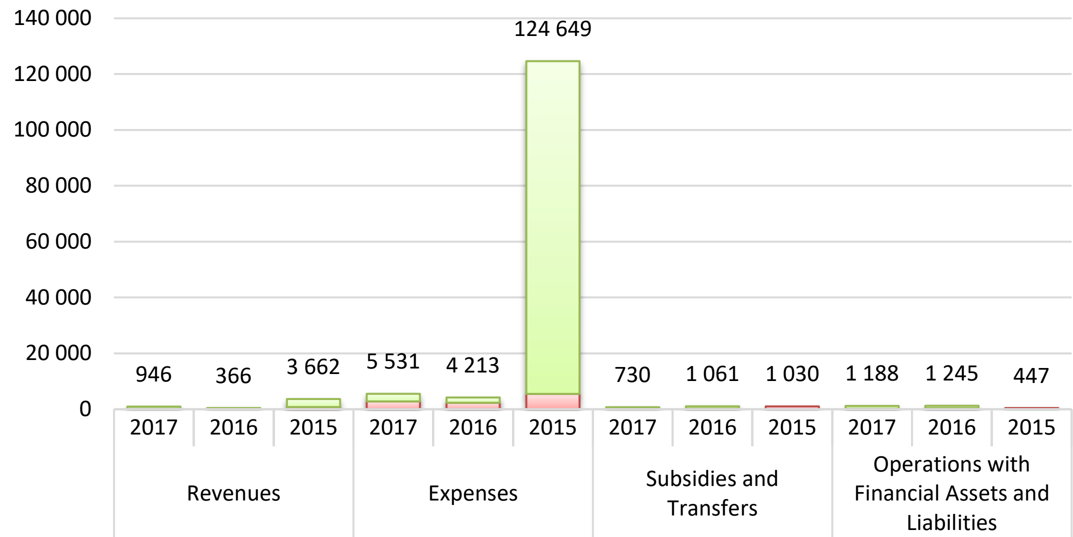
Adjusted and Non-Adjusted Misstatements in the Income Statements of Municipalities
(in thousands of euro)



	Revenues 2017	Revenues 2016	Revenues 2015	Expenses 2017	Expenses 2016	Expenses 2015	Transfers 2017	Transfers 2016	Transfers 2015	Revaluation and Other Events 2017	Revaluation and Other Events 2016	Revaluation and Other Events 2015
Adjusted	6 525	2 440		37 921	18 160		4 056	5 722		32 816	42 810	
Non-Adjusted	1 346	4 174		4 099	4 647		224	663		4 582	8 494	
Total	7 872	6 614		42 019	22 807		4 280	6 385		37 398	51 305	

Figure 6

Adjusted and Non-Adjusted Misstatements in the Budget Execution Statements of Municipalities
(in thousands of euro)



	Revenues 2017	Revenues 2016	Revenues 2015	Expenses 2017	Expenses 2016	Expenses 2015	Subsidies and Transfers 2017	Subsidies and Transfers 2016	Subsidies and Transfers 2015	Operations with Financial Assets and Liabilities 2017	Operations with Financial Assets and Liabilities 2016	Operations with Financial Assets and Liabilities 2015
Adjusted	790	34	2 867	2 718	1 877	119 145	678	808	0	971	835	0
Non-Adjusted	156	331	796	2 812	2 336	5 504	53	253	1 030	217	410	447
Total	946	366	3 662	5 531	4 213	124 649	730	1 061	1 030	1 188	1 245	447

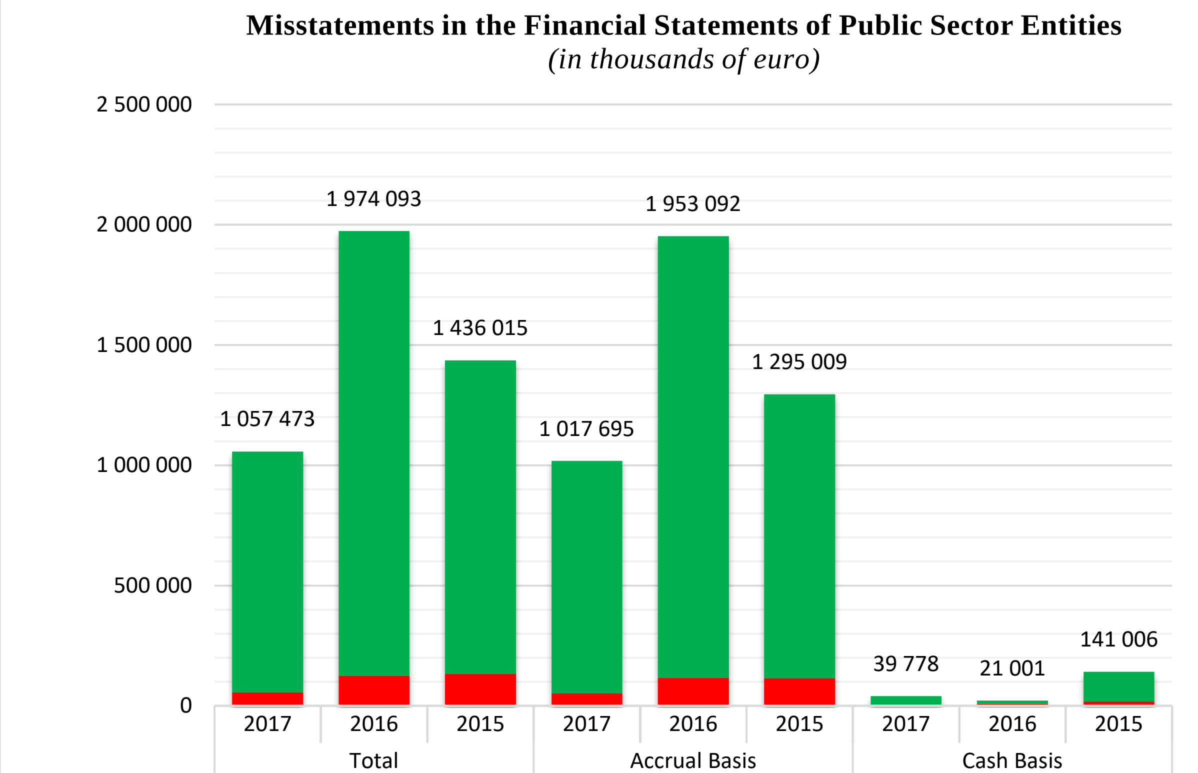
7. Main Conclusions from the Audits of the 2017 Financial Statements

The adjustments of misstatements in the financial statements of the public sector entities introduced as a result of the audits of the 2017 financial statements account for 1 billion euro, which is a decline by 46 % compared to the adjusted misstatements in 2016.

Some of the reasons for not introducing adjustments of misstatements in the financial statements are:

- Differences of opinion between the auditors and the public sector entities management regarding the accounting treatment and reporting of specific events, transactions and operations. Such differences of opinion may arise due to the contradictory legal framework, including the complex and sometimes unclear public sector financial reporting framework.
- Inability to adjust previous period misstatements that continue to influence the financial statements of the current reporting period.
- The accumulated sum of the misstatements is not significant and will not influence the audit opinion.

Figure 7



	Total 2017	Total 2016	Total 2015	Accrual Basis 2017	Accrual Basis 2016	Accrual Basis 2015	Cash Basis 2017	Cash Basis 2016	Cash Basis 2015
Adjusted	1 001 317	1 849 432	1 304 234	965 264	1 836 355	1 180 423	36 053	13 077	123 811
Non-Adjusted	56 157	124 661	131 781	52 431	116 737	114 586	3 726	7 924	17 195
Total	1 057 473	1 974 093	1 436 015	1 017 695	1 953 092	1 295 009	39 778	21 001	141 006

7.1. Weaknesses in the Preparation of Financial Statements

- All three groups of audited public sector entities (central government entities, public universities and municipalities) make similar mistakes regarding the **classification of revenues and expenses, assets and liabilities in the proper accounts of the Public Sector Chart of Accounts and respectively in the proper paragraphs and sub-paragraphs of the Uniform Budget Classification.** In our opinion, the above weaknesses are mainly due to the frequent amendments of the financial reporting framework, incl. insufficient guidance for its implementation issued by the Ministry of Finance (e.g. on recognizing adjacent land and facilities, classification of certain groups of non-current assets, etc.). Some individual additional instructions issued by the MF may also have a negative impact, since very often they introduce exceptions to the general rules.

- Incorrect calculation of depreciation expense following events leading to **changes in the depreciation schedule.**
- Failure to comply with the Ministry of Finance Guidance regarding **recognition of cost in the carrying amount of infrastructure sites,** land, forest and perennials, and heritage assets.
- Inadequate accounting treatment of the funds received and expended under EU funded programs such as: transfers; using funding from the EU programs accounts as short-term interest-free loans for the budget funded activities; taking loans from the central budget; keeping off-balance sheet statistics of the funds at the expense of beneficiaries, EU and other donors;
- Non-compliance with the MF guidance on mandatory review for **impairment of the non-current assets and for provisioning of receivables** conditioned upon the achieved collection rate;
- Failure to follow the MF guidance regarding off-balance sheet disclosure of the undertaken or implemented commitments and/ or new commitments for expenses, contingent claims and liabilities;
- Problems in identifying and applying the relevant principles in the Accountancy Act;
- Failure to comply with the rules for annual stocktaking of assets and liabilities.

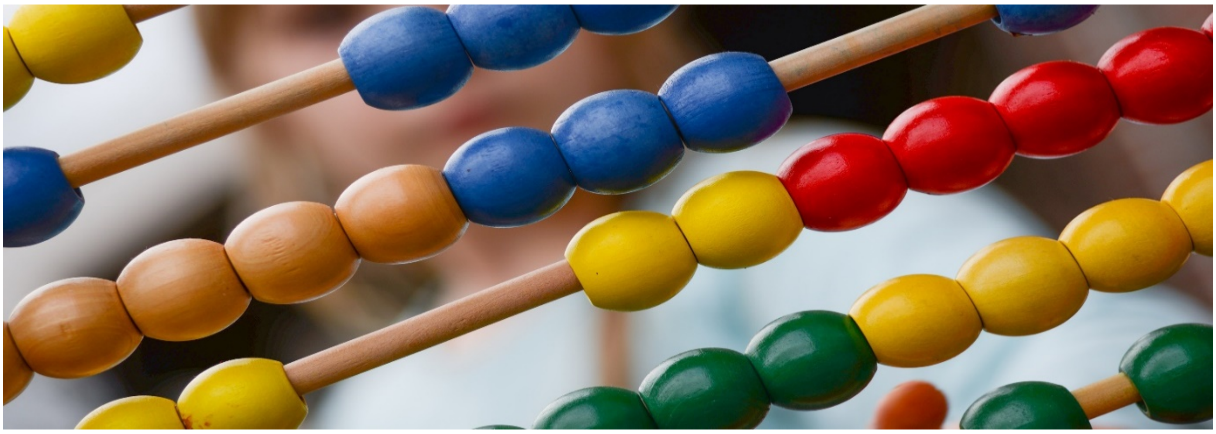
7.2. Weaknesses Related to the Organization of Accounting Processes

- The highest relative share of modified opinions (qualified and adverse) is contained in the audit reports on the municipal annual financial statements. This indicates an **insufficient administrative capacity** and **inefficient internal controls** at municipal level.
- **Audited public sector entities** are not required to set up **an adequate uniform electronic database** of all accounting records (on accrual and cash basis)**.** Using a uniform database when compiling the financial statements will reduce the risk of technical error in summarizing information, provide **traceability** and **do not limit the scope of the audit,** which is facilitated by computer assisted techniques.

The above weaknesses in the organization of the accounting processes were also identified during the audits of the 2015 and 2016 annual financial statements.

8. Conclusions

The benefits of good public sector financial reporting **are manifold** – meeting the needs of a large number of financial information users, improving public sector governance, increasing the confidence in the conduct of public business, etc. Therefore, there is a need for constant improvement of financial reporting in line with the best international practices – IPSAS and EPSAS (currently in development). The Bulgarian National Audit Office supports the Ministry of Finance’s efforts in this area, while at the same time providing an objective assessment of the current state of play.

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