

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

ACCOUNTING AND AUDITING

May 9, 2003

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Executive Summary

Financial reporting and auditing requirements in Romania are currently in transition from compliance with national standards to compliance with International Accounting Standards (IAS), International Standards on Auditing (ISA), and the European Union (EU) Directives.

In law, Romania seeks to attain maximum compliance with the EU Fourth and Seventh Directives and the EU Regulation on the use of IAS, and to create an environment for gradual implementation of IAS for both legal entity and consolidated financial statements by 2005. In practice, the imposition of complex IAS dealing with financial instruments, consolidation, and hyperinflation has been delayed. Currently compliance with IAS is not effectively enforced.

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 further complicated by the decision to require all but small- and medium-size entities to comply with IAS, which makes Romanian requirements more stringent than those of any EU Member State. Finally, the transition to full IAS will require a culture shift to reduce the influence of tax accounting on general-purpose financial statements.

In law, Romania seeks to attain compliance with the EU Eighth Directive and ISA. There are, however, serious practical problems because the current translation of ISA is out of date. The Chamber of Financial Auditors in Romania (CFAR) is using a translation based on a 1998 version that has not since been updated. This appears to be a resource problem rather than an attempt to hold back implementation. In practice auditors use a wide variety of audit opinion wordings—some of which are just plain wrong. The CFAR is implementing audit quality control reviews. While the CFAR 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 accession countries, as well as expected amendments to EU Directives, and recommends that the current self-regulation of the audit profession should be reviewed and an adequate oversight mechanism be 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 Romania in February 2003. The staff team was led by Frédéric Gielen (ECSPS). The review was conducted through a participatory process involving various stakeholders and led by the country authorities.

I. INTRODUCTION

1. This assessment of accounting and auditing practices in Romania is part of a joint initiative of the World Bank and the International Monetary Fund (IMF) to prepare Reports on the Observance of Standards and Codes (ROSC). The assessment focused on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting. International Accounting Standards (IAS)¹ and International Standards on Auditing (ISA) have served as benchmarks for the assessment, which involved a review of both mandatory requirements and actual practice.

2. Romania has a population of 22.4 million and Gross Domestic Product (GDP) per capita of US\$1,695. Inflation has remained high by regional standards (151 percent in 1997, 41 percent in 1998, 55 percent in 1999, 41 percent in 2000, and 30 percent in 2001). Indications of a progressive reduction in inflation toward a soft landing started to emerge in 2002 when year-end inflation fell to 17.8 percent.

3. There are 65 companies listed on the Bucharest Stock Exchange (BSE)—19 on the first tier and 46 on the second or base tier—with a market capitalization of US\$2.7 billion as of end-2002, which represents less than 10 percent of 2002 GDP.² The Romanian Association of Securities Dealers Automated Quotation (RASDAQ) was established in 1996 to enable trading in the shares of some 6,000 companies that, following the mass privatization program, were partially privatized to some 16 million Romanian citizens. As of end-2002, 4,823 companies were listed on RASDAQ with a market capitalization of US\$1.8 billion. There were 38 banks operating in the Romanian banking system, of which five held some 63 percent of the banking assets. There were 48 insurance companies, which wrote around US\$570 million in premiums in 2002 (about 23 percent life insurance and 77 percent property and casualty).

4. Since 1990, Romania's economic orientation has increasingly moved toward western Europe, with European Union (EU) membership a consensus goal among country leadership. European Union membership is currently planned for 2007 and has been a driving force in adopting such reforms as the Accounting Law 1991 (amended 2002) and the Auditing Law 1999 (amended 2002).

II. INSTITUTIONAL FRAMEWORK

A. Statutory Framework

5. **The Accounting Law was first published in 1991 and the most recent amendment was completed in August 2002 in an effort to comply with EU Regulations, Directives and Recommendations.** Ministry of Finance Orders 94 (amended 2001), 772/2000,306 (amended 2002), and 1784/2003 (amended 2003) are the instruments that effect the detailed regulations. The wording of secondary legislation (for example, Order 94) suggests that Romania's real priority is membership in the EU and that the country perceives its deadline as 2005 for full compliance with IAS. However, the Accounting Law and secondary legislation include specific

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

² The Bucharest Stock Exchange also has a "plus tier" (also known as the "transparency tier") where additional disclosure requirements apply. As of April 2002, there is only one company in the plus tier. Tier one or tier two companies may elect to be included in the "plus tier."

accounting requirements that may conflict with IAS and may undermine government efforts to implement reliable accounting standards. For example:

- Order 772/2000 requires that all companies exceeding two of the three following thresholds expressed in euro for the balance sheet total (Euro 4.8 million) and the net turnover (Euro 9.6 million), and in number of employees for the average workforce (250) prepare consolidated financial statements.³ While such thresholds are considerably lower than those in the EU Seventh Directive and its proposed amendments, such exemption from consolidation is incompatible with IAS 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*.
- Order 772/2000 also states that a subsidiary with “dissimilar” activities must be excluded from the consolidated financial statements when its inclusion would be incompatible with the true and fair view. This again is incompatible with IAS 27.
- Order 94 requires that enterprises present specific items on the face of the balance sheet and income statement (for example, extraordinary income and loss, and own shares shown as an asset) and allows that grants received not be separately presented, which may conflict with existing IAS and proposed revisions to IAS. Also, Order 94 includes special rules that permit the capitalization of formation expenses, which may conflict with IAS 38, *Intangible Assets*.
- Although Romania is hyperinflationary, as defined by IAS 29, *Financial Reporting in Hyperinflationary Economies*, IAS 29 cannot apply for the official financial statements under Order 94 filed with the Ministry of Public Finance.

6. **Under Order 94, large and listed companies are required to prepare their legal entity and consolidated financial statements “in conformity with IAS”.**⁴ Order 94 requires that listed companies,⁵ state-owned enterprises (*Regies autonomes*),⁶ national companies and other entities of national interest, and specific categories of entities that operate in the capital markets prepare their legal entity and consolidated financial statements in conformity with IAS from year 2000.⁷ However, the Ministry of Public Finance has since issued secondary legislation (referred to as “closing norms”) at year-end exempting companies from preparing consolidated financial statements in 2000, 2001, and 2002. This requirement will be gradually extended to other entities of a diminishing size until, in 2006, only small- and medium-size enterprises (SMEs) are excluded from the scope.

7. **Medium-size Romanian enterprises will face significantly greater financial reporting and audit burdens than SMEs in most, if not all, EU Member States.** By December 31, 2005, all companies exceeding two of three following thresholds expressed in euro for the

³ Order 772/2000 requires that banks, insurance companies, and listed companies prepare consolidated financial statements irrespective of the thresholds.

⁴ While Order 94 and other legislation refer to IAS, we caution the reader to the fact that there are significant differences between full IAS and Order 94. For convenience purposes, this report uses the same terminology as the Romanian legislation wherever possible, and highlights the differences with full IAS to inform the reader, where applicable.

⁵ Order 94 does not define “listed companies” but gives a list in the Appendix of all those on the Bucharest Stock Exchange and some companies on the RASDAQ.

⁶ The *Regies autonomes* are the national interest industries, such as utilities and the national companies, including such entities as railways. There are 16 of them.

⁷ The “other entities of national interest” and “specific categories of entities that operate in the capital markets” are catchall categories intended to cover all entities that fall outside specific legislation dealing with banks, insurance, and so forth. Some 82 companies fall into these categories.

balance sheet total (Euro 2.5 million) and the net turnover (Euro 5 million), and in number of employees for the average workforce (50) will be required to prepare their financial statements in conformity with IAS. Such thresholds are considerably lower than those in the EU Fourth Directive and its proposed amendments. Also, IAS-based financial statements are significantly more demanding than the average financial reporting requirements arising from the EU Fourth and Seventh Directive.

8. **Under Order 306, SMEs and initially larger entities excluded from Order 94 are allowed to prepare simplified financial statements in line with the EU Fourth Directive.** Order 306 is effective from 2003 so that the old accounting system remains in force for the majority of entities until 2002.

9. **Since 2002, all banks are required to present legal entity financial statements in conformity with accounting regulations set out by Joint Order 1982/5.**⁸ Beginning in 2003, all banks are also required to present consolidated financial statements in conformity with Order 1982/5. Order 1982/5 on specific accounting regulations for banks was first published in 2001 and was most recently amended in September 2002 and February 2003 in an effort to comply with the EU Banking Directive and IAS. The Order requires that banks always respect the provisions of the EU Banking Directive and some of the provisions of the IAS, which do not conflict with the Directive. Financial statements prepared in conformity with Order 1982/5 differ significantly from IAS (for example, major differences generally exist in the valuation of the loan portfolio, fixed assets, and share capital).⁹ Hence banks generally prepare at least two sets of financial statements—one set in accordance with Order 1982/5 for local purposes, including banking supervision, and one set in accordance with IAS for correspondent banks and other international users on a voluntary basis. Within four months of the year end, all banks must publish financial statements prepared in conformity with Order 1982/5 together with the auditor's report in the Romanian Official Gazette.

10. **A new Securities, Financial Investment Services and Regulated Markets Act (Securities Law) went into effect in 2002, but the lack of secondary legislation results in a legal vacuum.** The Securities Law requires that a publicly owned company presents audited semi-annual and annual financial statements prepared in conformity with the legal provisions in force (for example, Order 94 for an enterprise in the real sector or Order 1982/5 for a bank) and specific regulations yet to be issued by the National Securities Commission. While the Securities Law establishes an enhanced framework for the protection of investors, secondary legislation has not yet been enacted.

11. **The listing rules of the Bucharest Stock Exchange require that listed companies file their annual financial statements prepared in conformity with Order 94.** Companies listed on the “plus tier”¹⁰ must also post on their Website their quarterly financial statements prepared in

⁸ Joint Order 1982/5 from the Ministry of Public Finance and the National Bank of Romania dated October 8, 2001, also requires that a pilot group of nine banks prepare their financial statements in conformity with the Order's accounting regulations in 2001. In 2002, this requirement was extended to all banks. Beginning in 2003, the requirement is extended to all credit institutions, including credit cooperative institutions.

⁹ The December 31, 2001, audited financial statements of the second largest bank in the country show a Romanian Lei (ROL) 6,660 billion equity under Order 1982/5 compared to ROL 10,477 billion under IAS. However further analysis of IAS-based financial statements reveals that the larger equity under IAS is due to hyperinflationary accounting and that the bank has accumulated losses of ROL 5,203 billion. Such accumulated losses do not appear under Order 1982/5-based financial statements.

¹⁰ Refer to footnote 2 for explanation of “plus tier.”

conformity with Romanian Accounting Standards and IAS. There are no specific listing rules for companies on the RASDAQ, other than the regulations issued by the National Securities Commission. However, the RASDAQ is currently streamlining and increasing its standards for transparency.

12. **Recently, the insurance industry regulatory framework has made significant progress, but drawbacks remain due to pressure from certain market leaders and a lack of technical expertise.** Since 2002, all insurance companies are required to present legal entity and consolidated financial statements in conformity with accounting standards set out in Joint Order 2328, which represents significant progress compared to the previously applicable cash basis of accounting. Joint Order 2328 on specific accounting regulations for insurance companies was published in January 2002 in an effort to comply with European Directive 91/674/EEC and IAS. However, financial statements prepared in conformity with Order 2328, supplemented by so-called closing rules, differ significantly from IAS. For example, the use of IAS 29 and consolidation is not allowed when preparing financial statements for official use. If a company wants to apply these standards, an additional set of financial statements is prepared. Other major differences generally refer to existence of statutory technical reserves such as an “equalization reserve,” the valuation of assets admitted to cover technical reserves (including fixed assets), the valuation of policyholder liabilities, and revenue recognition.¹¹

13. **Under the Auditing Law 1999 (amended 2002), Order 94, the Banking Law, the Law on Credit Cooperative Institutions, and Joint Order 2328, a registered auditor should audit the legal entity and consolidated financial statements of the following enterprises:**¹²

- All enterprises that fall under the scope of Order 94—listed companies, state-owned enterprises (*Regies autonomes*), national companies, other entities of national interest, and specific categories of entities that operate in the capital markets from year 2000. From 2001 to 2005 this audit requirement will be gradually extended to other entities of a diminishing size until in 2006 when only SMEs are excluded from the scope.
- All credit institutions, except for credit cooperative institutions with less than 5,000 members, which may instead appoint one to three *censors*.
- Insurance and reinsurance companies.
- Companies regulated by the National Securities Commission.

14. **The legislation requires the National Bank of Romania and the National Securities Commission to accredit bank auditors and listed company auditors, respectively.** While the National Bank of Romania formalized its accreditation process, the National Securities Commission has yet to set out its accreditation mechanism. However, no auditor or audit firm has ever had its accreditation withdrawn as a consequence of an audit failure. The National Bank has accredited only the local member firms of international audit firm networks. No equivalents exist for insurance companies, but the Insurance Supervisory Commission has approached the Chamber of Auditors to consider whether the licensing of auditors of insurance companies should be different from that of mainstream companies.

¹¹ The December 31, 2001, audited financial statements of one of the largest insurance companies in the country show shareholders’ equity amounting to US\$6.8 million under IAS compared to US\$4.5 million under Order 2328.

¹² A registered auditor (individual or audit firm) is a member of the Chamber of Financial Auditors in Romania.

15. **While Order 94 requires that annual financial statements be filed at the Trade Registry, in practice audited financial statements are not readily available.** The World Bank ROSC consultant selected a sample of 20 companies listed on the BSE and approached the Trade Registry, which is obliged to make these reports public. The consultant was refused access to the reports; the Trade Registry representative cited “lack of proper authority” or the consultant was told the reports were archived and therefore no longer available. The ROSC team concluded that public access to the documents was de facto restricted.

B. The Profession

16. **The Chamber of Financial Auditors in Romania (CFAR) has 1,487 members, 1,013 of whom are registered as actively engaged in audit work.** Audit firms include local member firms of international audit firm networks, as well as strictly local firms and sole practitioners. The CFAR was established in 1999 and appropriated the privilege—reserved for members only—to audit financial statements, a privilege which was previously granted to members of the Body of Expert and Licensed Accountants of Romania (CECCAR).

17. **The law has recently granted to CFAR members the privilege of reserved function relating to the position of head of Internal Audit.** This decision may weaken CFAR’s position because it may be perceived as a business-motivated privilege rather than a decision that supports the public interest duties of its members.

18. **The CFAR’s technical resources are not adequate.** The CFAR does not have a full-time technical director or a department that is capable of conducting audit research or providing hotline support service to members. Although CFAR staff are helpful in communicating information on administrative and training matters, they appear to have insufficient technical knowledge and experience. The CFAR has not set up a volunteer technical committee that could draw upon the resources of local member firms of international audit firm networks to give expert advice.

19. **The Auditing Law 1999 (amended 2002) recognizes the profession as self-regulated and independent and requires CFAR to regulate professional performance as a matter of public interest.** Among procedures that the Law requires of CFAR are the following:

- Make recommendations to update legislation in line with EU legislation and standards from international professional organizations;
- Organize and conduct professional examinations;
- Organize and monitor continuing professional education;
- Maintain registers of auditors, including auditing firms and individuals;
- Develop a professional code of ethics for members;
- Develop, if necessary, professional audit rules and techniques; and
- Control the quality of audit activity and members’ professional conduct.

20. **The CFAR has much stricter guidelines for auditor independence than most EU Member States.** Article 32 of the CFAR’s constitution specifically prevents auditors from accepting nonaudit work from audit clients. The Chamber interpretation of strict independence does not accord with the current understanding of the “Big Four” firms, which usually employ

departmental barriers to demonstrate the independence of each of the multiple services they provide to audit clients. Article 32 has also been heavily criticized by local audit firms and sole practitioners. The CFAR's interpretation of independence has merit in public interest entities and is generally consistent with recent international developments.

21. **Observers note that the growing array of nonaudit services is a cause for legitimate concern about the independence and objectivity of auditors.** It is not uncommon for audit firms to offer tax and legal advice to their audit clients, including advice on establishing offshore entities and transfer pricing.

22. **The Auditing Law 1999 (amended 2002) requires that enterprise management should provide the auditors with the financial statements prepared by the enterprise.** But it is widely recognized that auditors prepare financial statements on behalf of their clients because clients lack financial reporting expertise and therefore expect the auditors to prepare them. However, clients emphasize that audit firms gradually transfer knowledge to company staff, who then can take over the drafting of financial statements.

23. **While auditors are subject to civil, disciplinary, administrative, and criminal liabilities, there have been no legal cases against auditors.** Auditors' civil liability is subject to the general rules regarding liability under the Romanian Civil Code (i.e., only actual damages, no consequential damages) and Government Emergency Ordinance 28/2002 regarding securities, as amended. Auditors are required by a decision of the CFAR to take out professional indemnity insurance in an amount at least equal to the auditor's annual gross audit fee income where such income is less than Euro 200,000; if income is greater than Euro 200,000, then the minimum insurance amount is set at Euro 400,000. Some audit firms include disclaimer provisions within their engagement letters limiting their liability (e.g., liability capped at the level of the audit fees). Romanian lawyers contend that contractual liability limitations embedded in the audit engagement letters would stand up in court, although this has never been tested. However, such limitations to liability are not enforceable against third parties.

C. Professional Education and Training

24. **A registered auditor must have acquired appropriate higher education, obtained relevant practical experience, and passed the CFAR examination.** The Auditing Law 1999 (amended 2002) complies with the EU Eighth Directive by requiring that an auditor accomplish the following:

- **To qualify as a trainee:** Acquired higher education in economics and four years of prior experience or the title of Chartered or Certified Accountant; passed knowledge tests in the financial and accounting area.
- **To qualify as an auditor:** Obtained three years additional practical experience in auditing; passed the CFAR examination on financial audit, general accounting, analysis of financial statements, consolidation, cost accounting, internal audit, accounting standards, auditing standards, commercial law, etc.

While these requirements represent a significant enhancement of those under the previous regime, the CFAR might also be persuaded to fast-track graduates with a specific accounting and audit degree over those with a current general economics degree. Such fast-tracking might restrict to three years the additional theoretical and practical training, followed by a final examination that tests skills at higher level than the exam used at present. The current requirement for membership in the CFAR offers an economics graduate another seven years of training before qualification.

25. **Auditors who had fifteen years of experience in finance and accounting at the date of effectiveness of emergency Government Ordinance 75/1999 were grandfathered upon passing an examination of professional competence organized by the CFAR.** Some 817 candidates were admitted as members of the CFAR in October 2000 and a further 603 in June 2001, signifying that approximately 78 percent of CFAR members were grandfathered.

26. **Universities have just started adapting their curriculum to the requirements of the new laws.** The lag time before new curriculum students graduate will range from four years (Bachelor's Degree) to six years (Master's Degree). The quality of accounting education is compromised by the lack of IAS training material in Romanian (textbooks, case studies, etc.). Also, both enterprises and audit firms highlight the need for more practical-oriented curricula through the involvement of practitioners at universities and internship programs.

27. **Universities could play a greater part in creating understanding of the free market approach among a younger generation of Romanians.** Many Romanian preparers do not understand the purpose of true and fair financial statements and remain unconvinced of the value of preparing two sets of financial information for a variety of audiences. Companies do not always appear to understand that accounting standards differ from fiscal requirements and that effective management and governance require additional information and criteria.

28. **Council Decision 9/2001 of the CFAR requires that members should participate in an annual minimum of 40 hours of continuing professional education (CPE).** The CFAR operates CPE programs that it established. Members must participate in at least 20 hours of CPE organized by the CFAR. Regarding the remaining 20 hours, members can attend CPE programs offered by other institutions. It is not clear how CFAR will enforce compliance with this recently introduced mandatory requirement and whether other institutions entitled to run CPE programs will be subject to CFAR monitoring.

D. Setting Accounting and Auditing Standards

29. **Accounting regulation is driven by the Ministry of Public Finance (MOF), which is also responsible for collecting national statistics and planning and collecting taxes.** Since the prime objective of an accounting standard-setter should be transparency and accountability, MOF's involvement in setting regulations may constitute a conflict of interest. Transparency and accountability may suffer from the albeit normal emphasis on statistics and tax. As prime user of statutory financial statements, the MOF is making best use of the five-year period to manage accounting reform in a way that avoids disruption in other areas. Once Romania complies with EU accounting requirements and once it has an acceptable tax reconciliation statement, the MOF should divest itself of accounting standard-setting to a suitable successor.

30. **The recently constituted Consultative Accounting College may grow into a national standard setter.** The MOF set up the Consultative Accounting College as an independent organization to take over the guidance, implementation, and research duties carried out by the Ministry.

31. **Accounting standards for credit institutions, insurance companies, and listed companies are set by the respective regulator and subject to approval by the MOF.** The National Bank of Romania issues accounting standards for credit institutions. The National Securities Commission sets out accounting rules and regulations for companies operating on the capital market, after approval by the MOF. The Securities Commission also issues regulations

and instructions, which are implemented through an order of its Chairman. The Insurance Supervising Commission has the authority to set accounting standards applicable to insurance and reinsurance companies for both regulatory and general-purpose financial statements. These standards are subject to prior approval by the MOF.

32. **The Romanian translation of International Accounting Standards is readily available and up-to-date.** The IAS are translated under a program managed by the Institute of Chartered Accountants of Scotland and funded by the Department for International Development in the United Kingdom. However, the Romanian version remains expensive by local standards. These concerns may be alleviated when Romania joins the EU, as IAS will then be published in the Official Journal.

33. **The Romanian translation of International Standards on Auditing is out-of-date.** The CFAR has prepared a Romanian translation of the International Federation of Accountants (IFAC) Handbook and, since the CFAR is not yet a member of IFAC, the translation has been performed under the supervision of the Chartered Accountants of Scotland with specific permission from IFAC. The translation has not been updated since 1998, apparently for lack of resources.

E. Enforcing Accounting and Auditing Standards

34. **The Stock Exchange of Bucharest and the National Securities Commission review the financial statements of listed companies for completeness and obvious errors.** The Corporate Action Department at the Bucharest Stock Exchange employs two senior economists who receive quarterly, semi-annual and annual financial statements. They review the financial statements for coherence and completeness but do not enforce accounting standards. The National Securities Commission has never ordered restatement and has levied fines only for late filing. While the sanctions foreseen under the Securities Law include civil liability for the preparers, the directors, and the auditors, no court case has been reported to date. In addition, the National Securities Commission has limited resources to review issuers' financial statements and relies almost entirely on auditors to check compliance with accounting standards. While two of the six staffers of the State Securities and Exchange Commission in charge of this important function have a sound economics education and received some IAS training, none is a qualified accountant. Observers indicated that there is a need for additional IAS training, especially as the business environment and the related accounting treatment become increasingly complex. The RASDAQ does not enforce accounting standards.

35. **The regulators have no arrangements for enforcing accounting standards that are applicable for general-purpose financial statements of banks and insurance companies.** The National Bank of Romania reviews banks' financial statements but the primary responsibility rests with the auditors.¹³ Although the National Bank of Romania has the authority to withdraw an auditor's accreditation, it has never done so because no discrepancies have been detected beyond doubt. The Insurance Supervision Commission has started only recently enforcing accounting standards.

36. **The CFAR is currently establishing procedures for quality control of audit firms and at its most recent annual meeting conducted a workshop on quality control.** The model will follow the United Kingdom model where each firm establishes its own system of quality

¹³ General-purpose financial statements are prepared based on the same accounting standards as those for regulatory reporting.

control against criteria established centrally. Each firm then submits annual returns certifying compliance with such criteria and attaching details. Inspectors are sent out to judge a sample of firms to check that the systems certified are operating correctly. The quality control system will be sold to members as a support service. The CFAR's main problem in this area is likely to be the recruitment of suitably experienced inspectors.

III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

37. **Romanian Accounting Standards, which are primarily set out in Order 94 supplemented by MOF closing rules, differ significantly from IAS.** Selected areas of difference include the following:

- Although IAS permit the addition to the basic formats of extra information, Romanian financial statement formats include masses of additional information, which can only confuse foreign shareholders and potential investors. The MOF uses statutory accounts in compiling national statistics. The EU Fourth Directive formats for financial statements have been superimposed upon a pre-ruled grid in which each row is numbered and each heading is cross referenced to a nationally recognized chart of accounts. Using one format to perform two functions is unhelpful when one of those functions is much-needed international investment.
- Order 94 prefers the EU Fourth Directive treatment of treasury shares as assets over the requirement of IAS 32, *Financial Instruments: Disclosure and Presentation*, to include them in equity.
- First year applicants of Order 94 are not allowed to provide comparatives, which contradicts IAS 1, *Presentation of Financial Statements*.
- The MOF tightly controls the implementation of IAS by issuing annual instructions ("closing rules") to preparers of financial statements. For example, the relevant paragraph in the 2002 year-end closing rule reads "...annual financial statements are prepared based on ... IAS except for IAS 29 (...) Legal entities that apply Order 94 are not required to prepare consolidated financial statements. For their own information requirements, entities may prepare consolidated financial statements to present to users of information, other than state institutions...." The effect of delaying the implementation of certain IAS creates a situation in which most Romanian audit reports and financial statements are clouded with uncertainty. This is especially true when one reflects on the importance of consolidation and hyperinflationary accounting in Romania.

38. **Romanian Accounting Standards relating to credit institutions, which are primarily set out in Joint Order 1982/5 and National Bank regulations, differ significantly from IAS.** Selected areas of difference include the following:

- The National Bank methodological norm requires banks to calculate impairment in the unsecured portion of loans and receivables on the basis of a provisioning matrix that specifies fixed provisioning rates for the number of days a loan has been classified as nonperforming. The National Bank regulations may not always be appropriate to calculate the recoverable amount of originated loans and receivables under IAS 39. IAS 39.111 requires impairment or bad debt losses to be calculated as the difference between the asset's carrying amount and the present value of expected future cash flows discounted at the financial instrument's original effective interest rate, which may differ significantly from the National Bank regulations.

- The National Bank regulations differ significantly from IAS regarding the revaluation of fixed assets.

39. **Banks' financial statements were generally of better quality than insurance companies financial statements.** When the IAS-audited financial statements of ten banks and insurance companies were reviewed, it was found that the banks carry out straightforward banking and securities transactions resulting in relatively simple financial statements. However, areas of possible conflict with IAS were noted. The related audit reports were not qualified, which may be because the auditors considered The following issues were not a material departure from IAS:

- **Consolidated financial statements.** The financial statements of some associates have not been restated in accordance with IAS and therefore the application of the equity method may not be correctly made in accordance with IAS 28, *Accounting for Investments in Associates*. Some companies did not present consolidated financial statements but accounted for investments using the equity method. The company's share of the results under the equity method was material and therefore the impact for consolidation would likely have been material.
- **Property, plant, and equipment.** Some sampled banks revalue properties every five years, which may mean that the carrying amount differs from fair value at the balance sheet date and may be in conflict with IAS 16, *Property, Plant, and Equipment*. Also observers suggested that valuations by independent appraisers may not be reliable. In addition, some sampled banks appear to use tax rules to determine accounting depreciation, which may not comply with IAS 16.
- **Amortized cost and revenue recognition.** It appears that transaction costs are included in the amortized cost calculation whereas the related fees charged to customers are recognized in income immediately. If this were the case, this may not comply with IAS 39, and would result in the overstatement of net income.
- **Measurement and disclosure of available-for-sale securities.** Some sampled banks carry all available-for-sale financial assets at cost-based amounts because no market price is available. This does not comply with IAS 39 because apparently the banks have not considered other methods for estimating fair value and the determination is not carried out on the basis of an individual investment. Also, these banks do not disclose the fair value of these securities.
- **Allowance for loan losses.** Some sampled banks appear to provide for loan losses in accordance with National Bank regulations rather than in accordance with IAS 39.
- **Fair value of loans and held-to-maturity securities.** All sampled banks disclosed that the fair value of the "loans originated by the bank and not held for trading" was equal to their net book value. This disclosure is unlikely to be correct and may mislead the reader as to the actual fair value of the loan portfolio because the fixed-interest rate loans are measured at amortized cost less impairment (computed based on the effective interest rate at inception), whereas the fair value should be determined in relation to the current interest rate. Also, some sampled banks and insurance companies did not disclose the fair value of held-to-maturity securities.
- **Presentation of the cash flow statement.** Many sampled banks do not disclose payments and receipts for interest and income taxes separately, as required by IAS 7, *Cash Flow Statements*. Also, some sampled banks erroneously classified operating

cash flows as investing or financing cash flows (for example, trading securities as investing cash flows rather than operating cash flows).

- **Held-to-maturity securities.** Some sampled banks are classifying a significant portion of their securities portfolio as held-to-maturity in circumstances, which may not meet IAS 39 definition.
- **Borrowing costs.** One sampled bank capitalized interest costs during the construction of assets while restating the cost of those assets using a general index. Because the impact of inflation is usually recognized in borrowing costs, it is not appropriate both to restate the capital expenditure financed by borrowing and to capitalize that part of the borrowing costs that compensates for the inflation during the same period.

40. **Information on “compliance gap” demonstrates serious weaknesses of corporate financial reporting in Romania.** The review of financial statements of 15 listed companies and interviews with experienced corporate accountants, practicing auditors, academics, professional bodies, and regulators revealed information about compliance gaps.¹⁴ In general, most companies’ knowledge of the detailed rules in Order 94 was good, but they had little knowledge of the disclosure requirements set out at the end of each IAS, as the following illustrates:

- **IAS and the Law.** Companies did not appear to understand that IAS required them to make judgments and often deferred to Romanian tax laws:
 - **Revaluation.** Four companies mentioned revaluations. None of these complied with IAS 16 requirement to state whether an independent appraiser was used.
 - **Depreciation.** All companies produced the correct analyses but only four provided the correct narrative IAS 16 disclosures. Five companies disclosed useful lives but stated that these were determined by Law 15, which supplies the rate required for tax computation purposes.
- **Explanatory notes.** Order 94, “Examples of explanatory notes” section concentrates on the need to describe exceptions and departures from accounting principles and does not clarify the need to explain the normal accounting policies and bases followed. As a result very few explanatory notes were available. One of the sampled companies interpreted these instructions literally and presented just three lines of explanatory notes: “There have been no changes in accounting policies this year. IAS 29 has not been applied. In calculating cost, interest charges have not been included.”
- **Inventories.** Inventory notes were frequently not available. Only two companies mentioned the criterion of “net realizable value.” The EU Fourth Directive does not specifically require this wording. One of the sampled companies disclosed finished goods at selling price and the auditor failed to comment.
- **Leases.** Three companies disclosed the existence of leases. Two of the sampled companies identified finance leases but appeared not to follow the IAS accounting treatment. Instead, they may have followed Romanian Ordinance 51/97 that defines operating and finance leases. The definitions are close to those of IAS 17, *Leases*, but allow no room for judgment.
- **Deferred tax.** Only two companies in our sample appeared to comply with IAS 12, *Income Taxes*. One of the sampled companies stated “There is no difference between the result for the year and the tax result.” Ten companies made no mention of

¹⁴ “Compliance gap” denotes the difference between applicable accounting standards and actual practice.

deferred tax, which might be explained by the fact that Order 94 does not mention deferred tax.

- **Foreign exchange.** IAS 21, *The Effects of Changes in Foreign Exchange Rates* requires foreign exchange differences to be disclosed separately. The EU Fourth Directive allows foreign differences to be grouped in other financial charges. Five companies disclosed transactions in foreign exchange but only one of the sampled companies disclosed the differences separately.
- **Revenue policy.** Nine companies in our sample failed to disclose any accounting policy for revenue and one of the sampled companies noted that “Revenues are recognized at historical cost” and the auditor failed to comment.
- **Inflation.** Only two of the sampled companies chose to provide IAS 29 financial statements in addition to the statements without compliance with IAS 29 demanded for filing purposes by the MOF. Their financial statements appeared to comply with IAS 29 and these companies clearly enjoyed the support of local member firms of international audit firm networks.

While most companies followed the Order 94 requirements, very few provided financial statements that would be readily recognizable as IAS-compliant. While Order 94 is sometimes construed as requiring compliance with IAS, it is cluttered with traditional advice that is followed by preparers and auditors to the exclusion of other requirements.

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

41. **Under emergency Government Ordinance 75/1999 there was no auditing standards gap, but Law 133—for approval of the Ordinance—amended the definition of an audit and thereby created a standards gap.** The Ordinance required that all audits should be carried out in accordance with ISA. Law 133 amended this provision and now requires that audits should be carried out in compliance with the auditing standards, harmonized with ISA, and approved by the CFAR. The use of the terms “harmonized with” and “approved by” rather than “in accordance with” may create confusion and eventually weaken auditing standards.

42. **The Romanian Standards on Auditing are published in a green paperback titled *Audit financiar 2000*, which is a Romanian translation of IFAC standards as they were in 1998.** Romanian Standards on Auditing need updating due to revisions of ISAs; for example, some major changes in ISAs relating to “Going Concern,” and “The Auditor’s Report on Financial Statements” need immediate consideration. Moreover, certain ISAs comparable auditing standards do not exist in Romania; these are ISA 240, *The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements*; ISA 260, *Communications of Audit Matters with Those Charged with Governance*; and ISA 505, *External Confirmations*. Several of the 13 International Auditing Practice Statements issued by the IFAC have not been kept up-to-date or adopted in Romania.

43. **While many audit firms make strenuous efforts to carry out audits in accordance with ISA, it appears that few shareholders, directors, and members of management understand the purpose of an audit, which makes audit evidence difficult to obtain.** 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 Romania. 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.

44. **Audit reports are very confusing.** During the review of financial statements of 15 listed companies, the ROSC team looked specifically at the way in which the various auditors' reports dealt with noncompliance with IAS 29. Despite the CFAR issuing suggested wording to disclose this situation that affects nearly all Romanian companies, the audit reports are still confusing. The CFAR recommended that its members issue an unqualified opinion that "financial statements are properly prepared in accordance with Order 94/2001 and Order 2332/2001" and an emphasis of a matter paragraph drawing the reader's attention to the fact that Order 2332/2001 does not require compliance with IAS 29. The way auditors handled the exact same issue in the sample under review varied considerably: a small number of auditors followed the CFAR's wording, some issued adverse opinions, some issued qualified opinions, and some issued an unqualified opinion as to compliance with IAS in spite of the fact that IAS 29 had been left out.

45. **In one of the ten sampled banks, the auditors expressed the opinion that the financial statements complied with IAS as disclosed in the notes.** This may imply that the auditors think that the financial statements do not comply fully with IAS.

46. **There is also conflicting evidence about the quality of insurance companies' audits.** Observers repeatedly indicated that audit firms generally do little audit work relating to the review of the actuarial assumptions and computations used for determination of the technical reserves. Foreign actuaries employed by insurance companies highlighted a lack of actuarial expertise within the audit teams they dealt with.

V. PERCEPTIONS ON THE QUALITY OF FINANCIAL REPORTING

47. **There is little demand for transparent financial statements due to underdeveloped capital markets, collateral-based lending, and a general lack of understanding of free market principles.** The low demand for financial statements is compounded by the perceived lack of reliability in financial information and decreasing foreign portfolio investment inflows. Interviews and discussions with institutional investors, foreign and local bankers, analysts, and various other users of corporate financial information showed concerns about the quality of financial reporting. Institutional investors differentiate between banks and companies listed on the Bucharest Stock Exchange where financial statements are perceived to be more reliable than those of other companies. Most interviewees shared a strong view that the quality of financial reporting would improve when there is a strong regulatory regime combined with effective enforcement mechanisms to ensure compliance with accounting and auditing standards and auditor's professional ethics.

VI. POLICY RECOMMENDATIONS

48. The following policy recommendations were agreed between the World Bank staff members, the Ministry of Public Finance, and country stakeholders represented by the Consultative Accounting College. It was also agreed that a detailed Country Action Plan would be developed and implemented on the basis of these policy recommendations. The Country Action Plan, developed by the Consultative Accounting College, will be implemented under the coordination of the Ministry of Public Finance and with assistance from international development partners.

49. **Accounting and auditing laws and standards.** The Accounting Law, the Auditing Law, the Banking Act, the Insurance Act, the Securities Law, as well as secondary legislation should be amended and other measures taken to incorporate the following recommendations:

- Remove existing discrepancies and avoid future inconsistencies with IAS and ISA. Toward that end, legislation should use the “in conformity with” or “in accordance with” terminology rather than “harmonized with” or “based on.”
- Provide SMEs with a reporting framework more adapted to their size than IAS.
- 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.
- Establish a sustainable system within 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.
- Establish a sustainable system within the CFAR (a) to enable immediate translation and adoption of new ISA and exposure drafts issued by the International Federation of Accountants; and (b) to issue implementation guidelines on individual ISA.

50. **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 National Bank of Romania 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 IAS-based 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.

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

- Publication of abridged financial statements 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 and the publication states where the full set of audited financial statements can be obtained.

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.
- The financial statements should be readily available to any interested user.

52. **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 National Securities Commission, the National Bank of Romania, and other regulators should review the IAS-based financial statements of all public interest entities and take appropriate action against those companies and their auditors when the financial statements do not comply fully with IAS and the auditor’s report has not been modified accordingly. The review should entail verifying the completeness of the financial statements and especially the notes thereto, the coherence and reasonableness of financial statements, etc. For listed financial institutions the regulators should coordinate with the National Securities Commission.
- The CFAR should develop the nascent 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 (e.g., the National Securities Commission, the National Bank of Romania) 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 representatives from within and outside the auditing profession should participate in the work of the oversight body. The majority should be from outside the profession.

53. **Take measures to enhance the independence of the CFAR from the Ministry of Finance, including the independence in appearance.** The CFAR should promote regional representation on the CFAR Council and promote a regional network of discussion groups.

54. **Strengthen the capacity of the CFAR by establishing twinning arrangement with a developed professional accountancy body.** In view of the recent worldwide developments with regard to the regulation of accountancy profession and reform of the role of professional bodies, it is necessary to take immediate steps for strengthening the governance structure of the CFAR. In this regard, an arrangement needs to be made for long-term twinning arrangement between the CFAR and a developed professional accountancy body. Through the twinning arrangement, knowledge transfer will take place to facilitate replicating twinning partner's model in Romania.

55. **Professional education and training.** In adopting IAS and ISA, Romania has set very challenging and demanding objectives for itself. This translates into a need for related education and training for auditors, tax administrators, and regulators. Training plans should encompass some of the following areas:

- Develop an accounting curriculum at college and universities that meet the needs of corporate Romania. 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 Romania.
- Review and update the accounting curricula in order to incorporate IAS and ISA and practically oriented teaching at the undergraduate level in higher educational institutions. The ethical dimensions of business management, corporate finance, accounting and auditing should be taught with case studies in the undergraduate programs of business schools. Particular attention needs to be given to increasing the critical thinking skills of the students. To enhance the capacity of higher educational institutions to teach accounting and auditing courses with international components, there is a need to organize a training-the-trainers program.
- Provide meaningful theoretical and practical training of IAS to the staff of the National Securities Commission, the National Bank of Romania, the Insurance Supervision Commission and other regulators so they can enforce accounting standards as recommended.
- Organize additional IAS and ISA training, including practical training and coaching, for grandfathered auditors where recommended by the CAFR quality assurance review.
- Implement continuing professional education that conforms with the IFAC guidelines and standards. There will be a need for monitoring and enforcing these requirements. The CFAR should recognize CPE courses offered by authorized training providers and ensure that courses offered include electives so practicing auditors can choose to attend courses that best meet their continuing education needs.