

**COMMISSION FOR PUBLIC
OVERSIGHT OF STATUTORY
AUDITORS**

2010 Annual Activity Report

SUMMARY

The main priorities pursued by the Commission for Public Oversight of Statutory Auditors (hereinafter referred to as 'the Commission'; 'CPOSA') in its 2010 activities were related to the implementation of requirements laid down in the Independent Financial Audit Act (IFAA) and Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, as well as assessing, and informing the public of the quality of audit services delivered and their compliance with the international auditing standards and the Code of Ethics for Professional Accountants.

The amendments and supplements to the Independent Financial Audit Act adopted by the National Assembly have contributed to a better codification of the tasks and responsibilities of the Commission as the competent authority entrusted with the oversight over statutory auditors and audit firms, as well as the effective cooperation at Community level in respect of the EU Member States' oversight activities.

In accordance with the amendments to the IFAA, the Commission approved modifications to its Rules of Procedure and other internal by-laws. Owing to the restrictive budget cuts in the first fiscal semester, the Commission implemented changes in its structure and downsized its administration from 30 to 25 employees.

The good organizational system which was created and the increased budget for the second semester enabled the Commission to fully implement its annual program of activities and to increase oversight effectiveness. The reviews of the quality of work of statutory auditors were conducted as planned, in addition to 21 investigations based on reported irregularities, including ones from the Ministry of Environment and Water, the Financial Supervision Commission and the National Audit Office.

Based on the completed reviews and an analysis of the overall activity of the Institute of Certified Public Accountants, specific measures were adopted and are already being implemented in respect of awarding qualifications and registration of certified public accountants (CPA) and statutory auditors. Specific requirements governing the registration of auditors and audit firms from EU Member States were also specified. In order to improve the quality of audit services, changes were introduced to the rules for continuous training of auditors and the quality control rules and procedures. Recommendations were given to launch a new examination procedure deploying an electronic system for assessment of the examination results of candidates applying for CPA qualification.

The 2009 experience contributed to the expansion of the scope and procedures of audit services quality control. In 2010, time and human resources allocated to audit assignments were reviewed and assessed in terms of their adequacy; so was the adequacy of audit fees. For the first time, administrative measures were imposed upon auditors who failed to implement recommendations given by the Commission. CPOSA inspectors, assisted by controllers of the Institute of Certified Public Accountants of Bulgaria, conducted a total of 113 control procedures (86 planned quality control

reviews; 6 recommendation follow-up checks; and 21 investigations based on reported irregularities or on the Commission's own initiative).

The measures taken resulted in positive changes in the setting up of internal quality control systems, documenting audit procedures, and in ensuring that the deployed time and human resources comply with the scope and complexity of audit assignments. Nonetheless, the activities of some of the statutory auditors do not correspond to the statutory requirements and good European and global practices. Specific recommendations were given in order to rectify the deficiencies ascertained by the inspectors and controllers; the relevant follow-up checks are pending.

The Commission continues to develop its cooperation with oversight and regulatory bodies of EU Member States, as well as with the competent authorities of third countries. In addition, the Commission actively and regularly participates in the activities of the European Group of Auditors' Oversight Bodies (EGAOB) and the International Forum of Independent Audit Regulators (IFIAR). It was also intensely involved in the discussion concerning the *GREEN PAPER. Audit Policy: Lessons from the Crisis* published by the European Commission. Since 2010, CPOSA has been representing Bulgaria in the Audit Regulatory Committee, which assists the European Commission in the development of audit regulation measures.

The website of the Commission ensures publicity and transparency of its overall activity. The information materials were structured in compliance with the modern developments of accessibility and user-friendly IT environment. In 2010, the creation of a dedicated e-mail address enabled the reporting of irregularities by any persons concerned.

The first (full) three-year cycle of reviewing the quality of work of specialized audit firms and of auditors conducting audits of undertakings whose activity is of public interest will be completed in 2011. Based on consolidated results, the audit service quality level will be evaluated, and the objectives and tasks of the future activities of the Commission will be updated accordingly.

I. OVERSIGHT ACTIVITIES

In 2010, CPOSA undertook action to increase the effectiveness of oversight activities in respect of the quality of audit services, while taking account of the impact and risks resulting from the global economic crisis.

The activities of statutory auditors in 2010 were concerned with the audits of the annual financial statements for 2009, when the economy of Bulgaria was most severely affected by the global financial and economic crisis. The negative effects inexorably influenced the market of audit services. Their strong impact is primarily manifested in two aspects of audit activities: the pricing of audit services and the fulfillment of contractual obligations by clients.

Under these conditions, when discharging its statutory duties, the Commission directed its action towards the following tasks:

- Review and analysis of the activity of the Institute of Certified Public Accountants in terms of awarding qualifications and registration of certified public accountants and statutory auditors; continuous training and professional upskilling of certified public accountants; approval of changes to the currently applicable rules and procedures that regulate the aforementioned activities;
- Expanding the scope and streamlining of the procedures for audit services quality control;
- Enhancing the cooperation with the relevant bodies of the European Union, EU Member States and third countries; gaining insight into the good practices in the field of financial audit oversight;
- More extensive implementation of the principle of publicity and transparency of the activities of the Commission.

In order to successfully accomplish these tasks, the Commission put significant effort in expanding and improving the internal by-laws. The following internal instruments were developed and adopted during this reporting period:

- Rules for conducting investigations based on reported irregularities and proposals sent to the Commission for Public Oversight of Statutory Auditors;
- Procedure for creating and processing administrative penalty case files until the issuance of a penalty order or another individual administrative instrument;
- Internal rules for data protection within the Commission for Public Oversight of Statutory Auditors;
- Rules and procedures for archiving oversight documents and information.

In 2010, the Commission also amended the following internal by-laws:

- Rules of Procedure of the Commission for Public Oversight of Statutory Auditors (compliant with the amendments to the Independent Financial Audit Act), including the implementation of structural changes concerning the administration staff;

- Rules concerning the procedure to disclose information on the website of the Commission for Public Oversight of Statutory Auditors;
- Statute of non-staff inspectors of the Commission for Public Oversight of Statutory Auditors.

1. Oversight over the activities of the Institute of Certified Public Accountants (ICPA)

In 2010, the activities of the ICPA targeted the improvement of the statutory framework regulating the audit profession, the enhancement of international cooperation and the development of training and methodological activities, publishing activities, and control activities of the Institute. The members of the Managing Board (MB) were actively involved in the preparation of draft proposals to amend and supplement the IFAA.

Positive changes were implemented in the training/methodological and publishing activities of the Institute, with action directed mostly towards streamlining the way CPA qualification examinations are organized and held and towards maintaining the existing qualification of certified public accountants and statutory auditors.

When pursuing its main priorities – and based on the conclusions reached in 2009 as to the activity of the ICPA – the oversight exercised by the Commission within the reporting period focused on the following activities of the ICPA:

1.1. The award of qualification and registration of certified public accountants and statutory auditors

The Commission reviewed and analyzed the activity of the ICPA in terms of awarding qualifications and registration of certified public accountants and auditors. The review was conducted on the bases of reported irregularities which pointed to deficiencies and weaknesses related to the way the CPA qualification examinations were organized and examination results evaluated.

The analysis indicated a clear need to improve the statutory framework in order to increase the objectivity and transparency of the process and to regulate the procedures and conditions applicable to holding CPA qualification examinations and entering (in the Register of Statutory Auditors) the names of practitioners who have obtained their qualification in another EU Member State, a State of the European Economic Area, or a third country.

In 2010, the Commission approved an amendment to the Rules for organizing and holding CPA qualification examinations that enabled a repeated review of the examination papers of CPA applicants as to their substance, when certain circumstances have occurred.

In connection with a report filed with the Commission, a review was conducted on the activity of the ICPA in order to establish whether the IFAA requirements as to proving the relevant professional experience – at the time of applying for a CPA and at the time of registering practitioners in the register of the Institute – are observed. Based on the results of the review, the Commission recommended that the ICPA should develop and adopt internal rules which are to specify the activities and documentation required from CPA applicants and statutory auditors to prove their

professional experience. The Commission also recommended that the registers of the ICPA should be brought in compliance with the requirements of the IFAA.

The Commission approved Rules for organizing and holding CPA qualification examinations and for registering statutory auditors who have obtained qualifications in another EU Member State, or a State of the European Economic Area, authorizing them to sign audit reports and to express an audit opinion concerning financial statements.

As to awarding qualifications to persons from third countries, the Commission asked the ICPA to develop another set of rules and to submit them for approval.

1.2. Organization and effectiveness of audit services quality control

CPOSA's effort of in this area is oriented towards introducing changes to the statutory framework and further developing the existing methodology. On account of the action taken and the amendments to the IFAA adopted in 2010, the competences of CPOSA and ICPA were differentiated in terms of quality control over the activities of statutory auditors. Quality control reviews of the work done by statutory auditors auditing undertakings whose activity is of public interest are conducted by CPOSA, and the activities of all other statutory auditors are reviewed by ICPA's Audit Quality Control Board (AQCB) under the Commission's oversight.

Amending the rules and procedures and expanding the scope of reviews for quality control over the work of statutory auditors enabled a more objective, comprehensive evaluation of the quality of audit services delivered by statutory auditors.

In order to exercise effective oversight over the activities of statutory auditors and the ICPA, while taking into account the good international practices, the Commission undertook:

- a balanced approach to regulation considering the benefits and costs related to regulations;
- a gradual transition to risk-based oversight;
- active cooperation with other oversight bodies;
- automation of the procedures for processing of information collected during reviews and/or investigations, including the results thereof.

1.3. Continuous training and upskilling of certified public accountants and statutory auditors

With a view to improving the statutory framework and increasing the effectiveness of continuous training of statutory auditors, it was in 2009 that CPOSA made recommendations to the management of ICPA to modify the then-applicable rules.

In order to implement the recommendations of the Commission, the ICPA adopted amendments and supplements to the existing rules for continuous training, which were approved by CPOSA. The changes mostly concern training objectives, conditions for maintaining an awarded qualification, recognition of training forms, performance review and verification. The changes also regulated the possibility to obtain feedback from trainees, which lays the foundation for a full implementation of the recommendations of the Commission.

2. Quality control of statutory auditors' work

In 2010, the Commission's quality control action over statutory auditors' work was in compliance with the legal framework and methodology as amended.

2.1. Level of execution of the annual program for quality control of statutory auditors' work

In accordance with the responsibilities specified in IFAA Article 35e(1) and Chapter 8, the Commission's major task is audit quality control.

Quality control procedures are fulfilled in conformity with the law and valid rules and the scope of reviews covers:

- compliance with the requirements laid down in the International Audit Standards for audit assignments;
- compliance with ethics and independence requirements;
- assessment of the internal quality control system;
- establishing how adequate audit time and human resources are in terms of the audit's scope and complexity;
- establishing the adequacy of audit fees.

In 2010, the Commission carried out a total of 86 audit quality control reviews. Reviews covered the auditors' reporting period from June 1st, 2009 through June 30th, 2010 and the activity of 20 specialized audit firms and 66 statutory auditors. Three of those 86 reviews could not provide quality evaluation due to the fact that the respective auditors did not have audit assignments during the review period.

Reviewed statutory auditors and audit firms conducted 4,017 audit assignments, 574 of which were audits of undertakings whose activity is of public interest.

The Commission's inspectors reviewed the quality of 276 audit assignments which makes 7% of the total number of audit assignments for the review period and 69 reviewed assignments more than the previous year. 132 were independent financial audit assignments of undertakings whose activity is of public interest: this represents 48% of the reviewed sample and 23% of the total number of assignments of this type.

The auditors reported 55,466 working hours for the reviewed sample, which is 12% of the total work time of 471,510 reported by the reviewed practices.

Statutory auditors and audit firms issued the following opinions by virtue of the reports from reviewed assignments:

- 231 reports expressed unqualified opinions (84% of the review sample) including 36 opinions with emphasis of matter;
- 40 reports expressed qualified opinions (16% of the review sample) with reservations (if the audit scope was limited or there was disagreement with the company management);
- Two reports expressed adverse opinion;
- Three reports expressed disclaimer of opinion.

2.2. Thorough quality assessment for statutory auditors and audit firms

As a result of the measures introduced by the Commission, audit quality control reviews are more detailed and cover a broader range of statutory auditors' activities compared to the previous year. This is a good basis for making objective and thorough quality assessments of audit practice and recommendations to improve audit work.

Thorough assessments are shaped on the assessment of audit practice along the four major quality control aspects:

- compliance with the requirements laid down in the International Audit Standards for individual audit assignments;
- setting up and operating an internal quality control system;
- adequacy of audit time and human resources in terms of the audit's scope and complexity;
- adequacy of audit fees.

In 2010, CPOSA adopted decisions endorsing 83 reports on the results of completed planned annual reviews with the following overall audit quality assessments:

- 51 audit practices received an "A" (no material deficiencies in the design and operation of the auditor quality control system, the execution of audit assignments, the adequacy of time and human resources and audit fees), representing 61% of reviewed practices (the same as in 2009);
- 24 audit practices received a "B" (there are sporadic material deficiencies in the design and operation of the auditor quality control system and/or the execution of audit assignments and/or compliance with the requirements for adequacy of time and human resources and/or audit fees), representing 29% of reviewed practices (compared to 26% in 2009);
- 5 audit practices received a "C" (there are systematic material deficiencies in the design and operation of the auditor quality control system and/or the execution of audit assignments and/or compliance with the requirements for adequacy of time and human resources and/or audit fees), representing 6% of reviewed practices (compared to 11% in 2009);
- 3 audit practices received a "D" (there is a deficiency which places in jeopardy the design and operation of the auditor quality control system and/or the execution of audit assignments and/or compliance with the requirements for adequacy of time and human resources and/or audit fees), representing 4% of reviewed practices (compared to 2% in 2009).

Review reports gave recommendations on overcoming material deficiencies and improving the overall operations in audit practices.

In 2010, based on the amended and supplemented quality control rules and procedures for statutory auditors, reviews focused for the first time on the adequacy of time and human resources and the fees for audit assignments.

In the approved CPOSA annual program ICPA controllers should carry out 73 quality control reviews of statutory auditors who performed independent financial audit solely of undertakings whose activity is not of public interest. CPOSA decided

that three reviews should be carried out with the involvement of Commission inspectors and the rest should be done by ICPA controllers alone.

Towards the date of this report, the AQCB submitted 54 case files; 4 of them were completed without giving a quality score due to the fact that the relevant auditors did not do audits during the review period.

Based on the reports adopted by AQCB the following quality scores were attributed:

- 32 of the reviewed practices or 64% received an “A”;
- 17 of the reviewed practices or 34% received a “B”;
- One of the reviewed practices or 2% received a “C”.

2.3. Follow-up checks on the recommendations to overcome material deficiencies and non-conformities

In 2010, pursuant to the amendments to the Rules of Procedure for quality control of statutory auditors’ work, the first follow-up checks were conducted to establish the extent of implementation of recommendations on overcoming deficiencies and non-conformities found during 2009 quality control reviews. 6 follow-up checks found that all statutory auditors except one took the necessary action to overcome those deficiencies in their audit practices.

One auditor failed to meet the recommendations and the same deficiencies reoccurred. Therefore, the auditor was issued an administrative violation writ and fined.

The Commission adopted a decision to focus this year’s follow-up checks on statutory auditors who got a C or D score in 2010.

2.4. Investigations of reported irregularities and proposals submitted to CPOSA by concerned parties

Pursuant to the provisions of IFAA Article 35e(2) item 5, the Commission should investigate reports of suspected irregularities and proposals by concerned parties and some other cases of its own discretion. The investigation procedure is regulated in the Rules for investigating irregularity reports and proposals submitted to CPOSA. The Rules were adopted during the reporting year.

In 2010, CPOSA received 13 reports for suspected irregularities committed by statutory auditors, two came from the Ministry of Environment and Water, one came from the Financial Supervision Commission and one came from the National Audit Office. The remaining whistleblowers were mainly statutory auditors, applicant certified public accountants and one shareholder in a public company.

The Commission decided to carry out 21 investigations. 10 reported irregularities were investigated in the course of the year, 8 investigations were part of the annual control plan and all 8 were completed, 3 investigations were conducted on the Commission’s own initiative.

Whistleblowers were notified promptly of the Commission’s decisions concerning competence based actions and investigation outcomes.

In 2010, as a result of investigations two statutory auditors were issued 3 administrative violation writs and were fined.

On the basis of investigation findings, the relevant auditors received recommendations and submitted implementation plans to CPOSA. Based on the Commission's decision, six investigated auditors are included in the full quality control review section of the following annual program.

To ensure transparency and protect the public interest, CPOSA publishes on its website its rules of investigating reports and proposals and the outcomes of investigations.

In the reporting year, CPOSA took some action to collect feedback from reviewed statutory auditors. The survey showed increased confidence in the work of the oversight body and a perceived positive impact on the quality of audit services. Respondents provided constructive quality control suggestions that will be reflected in the Commission's operations in 2011.

3. International cooperation

In 2010, the Commission for Public Oversight of Statutory Auditors pursued its collaboration efforts with EU Member States' oversight and regulatory authorities and the competent authorities of third countries.

The Commission took active part in the meetings of the European Group of Auditors' Oversight Bodies (EGAOB), including in the Inspections, EU Cooperation and Third Countries subgroups.

In relation to the discussion organized by the European Commission on the Green Paper *Audit Policy: Lessons from the Crisis*, CPOSA initiated a round table involving ICPA, the Bulgarian National Bank, the Financial Supervision Commission, and the Ministry of Finance among others. The topics that were discussed covered: the auditor's role, international audit standards, management and independence of audit firms, oversight, market saturation and structure, creating a European market, etc. The conclusions of that discussion were summarized and sent to the European Commission as CPOSA's official position on the Green Paper.

The Commission is a regular participant in the proceedings of the International Forum of Independent Audit Regulators (IFIAR) being a member since 2009.

Since 2010, CPOSA has represented Bulgaria in the European Commission's Audit Regulatory Committee, which is comprised of representatives from all EU Member States and assists the European Commission with the development and implementation of audit regulation measures.

4. Publicity and transparency of activities

In 2010, CPOSA continued strengthening the publicity and transparency of its work in order to improve public confidence in the institution and the activity of statutory auditors.

CPOSA's website provides information on its overall activities. The information materials are structured in compliance with modern developments of accessibility and user-friendly IT environment. The website publishes promptly the outcomes of reviews, the annual program and the annual activity report; CPOSA's opinions and decisions; training information; statutory documents related to CPOSA's

operations; information on international action and cooperation, news and press releases. The website contains information on CPOSA's activities in English as well.

A dedicated email account was set up on CPOSA's website specifically for whistleblowers.

II. INSTITUTION BUILDING AND ADMINISTRATIVE CAPACITY

In the course of the reporting year and on the basis of previous experience with the implementation of IFAA provisions, CPOSA developed proposed amendments to the IFAA and submitted them to the Parliamentary Committee on Budget and Finance. Several proposals changes were reflected in the official amendments promulgated in the State Gazette, issue 54 dated July 16th, 2010.

The newly amended act reduces the number of CPOSA members from seven to five and the Commission's decision-making majority and quorum rules are changed accordingly. The amendments also deal with members' pay which is based on members' participation in CPOSA's meetings.

The Commission for Public Oversight of Statutory Auditors is an independent body and a legal entity funded by the state budget through the budget of the Financial Supervision Commission.

CPOSA's operations are assisted by general and specialized administration, which was organized in three directorates at the beginning of the reporting period and in one directorate and two departments in the second semester.

CPOSA's staff composition in terms of level and type of educational background corresponds to CPOSA's goals and functions. Out of 24 employees total, 92% have masters degrees form higher education institutions. Twenty employees have economic degrees, one has a degree in law and one has a degree in engineering. Three of the employees have both a degree in economics and law. Three are certified internal auditors.

Due to the high qualification and experience requirements for CPOSA employees, the average age of CPOSA personnel is 45 years.

A key CPOSA priority is the ongoing strengthening of employees' knowledge and skills. The specialized administration receives at least 80 hours of training per year, the main topics being changes in the international audit standards and their impact on the work of statutory auditors.

In this reporting year, all employees had different trainings to improve their professional and personal skills.

CPOSA continues tapping on the experience of other oversight bodies in the context of the economic crisis and its impact on statutory auditors' skepticism. The training organized by the Institute of Chartered Accountants in England and Wales on audit quality control is coming to an end.