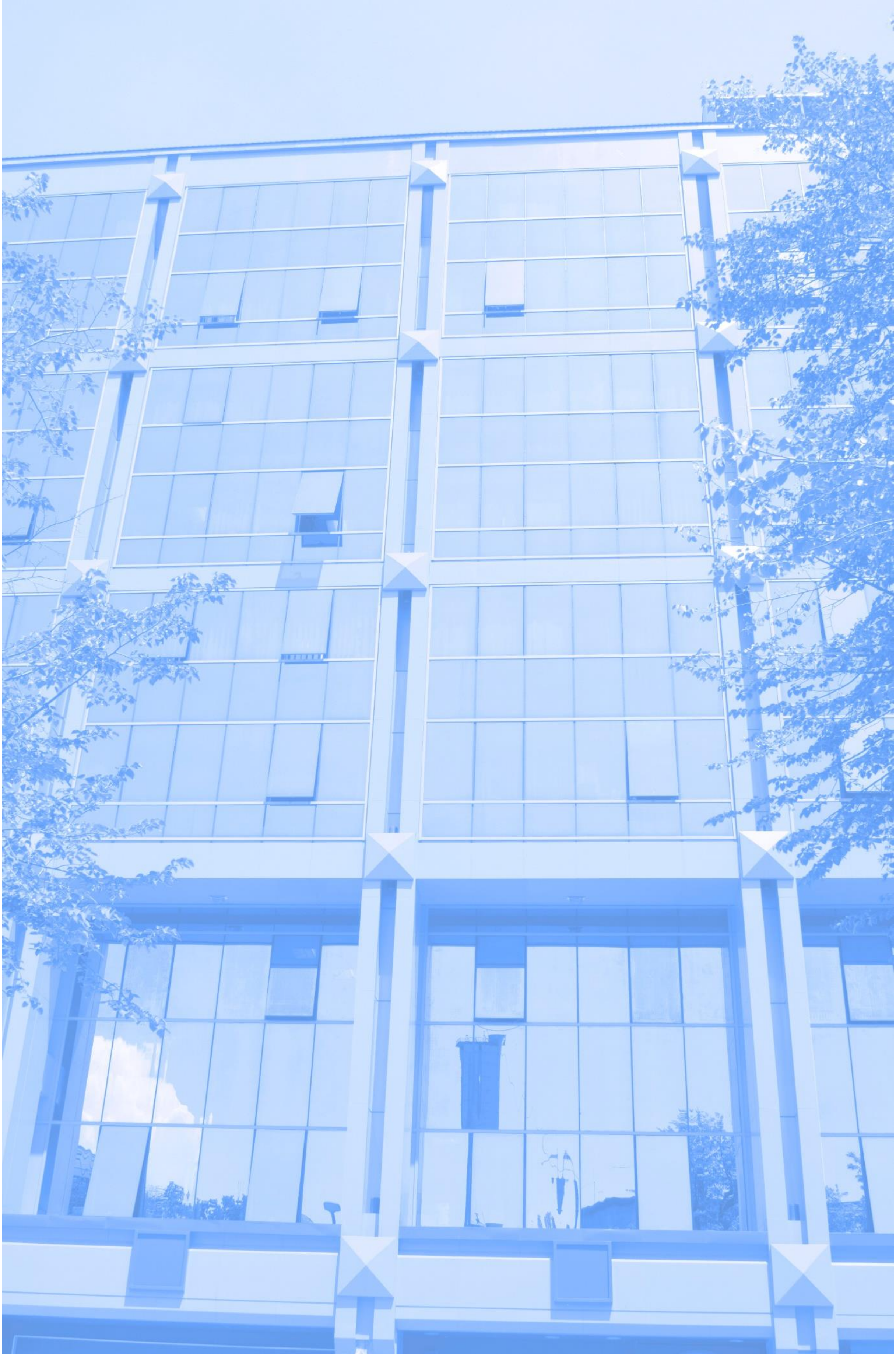
REPORT

on the Outcomes of the Financial Audit Engagements conducted by the Bulgarian National Audit Office in 2021

BULGARIAN NATIONAL AUDIT OFFICE



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1. Goals of Financial Auditing

In 2021, the Bulgarian National Audit Office (BNAO) audited the 2020 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 aspects, in accordance with the applicable financial reporting framework. Therefore, the audit opinion does not provide assurance neither on the future viability of an organization, nor on the effectiveness or efficiency of its management. It aims at increasing 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** whether the financial statements as a whole are free from material misstatements due to fraud or error. An audit opinion may be **unmodified, qualified or adverse**.

The unmodified audit opinion indicates that **the audited financial statements are free from material misstatements** and that the notes to them do not contain any omissions of non-financial information that is of relevance to the users. The financial statements on which BNAO has expressed an unmodified opinion **present a true and fair picture** of the financial position, financial performance and cash flows of the respective public sector entity. BNAO issues **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 **provide a true and fair representation** 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 BNAO has issued an adverse opinion **do not provide a true and fair representation** of the financial position, financial performance and cash flows of the public sector entity. In exceptional cases, when the circumstances[1] prevent the auditors from performing the necessary audit procedures**,** 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 provide 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 this audit** are predicated upon two factors. Firstly, whether the audit is conducted in line with the internationally accepted standards on auditing and secondly, whether the applied public sector financial reporting framework contributes to improving the quality and transparency of financial reporting that informs the management's decision-making process.

2. Applying the internationally accepted standards on auditing

BNAO adheres to the principles and procedures set out in International Standards on Auditing (ISA) and the International Standards of Supreme Audit Institutions (ISSAI). 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 an 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 on auditing. A significant portion of the requirements in the auditing standards (included also in the Manual) relate to quality control through monitoring the implementation of the ISSAIs based on policies and procedures.

3. The 2020 Financial Reporting Framework

The financial reporting in the Bulgarian public sector is regulated mainly through the following:

- Law on the Public Finances;
- Accountancy Act;
- National Accounting Standards (repealed, but still in effect for the public sector entities);
- Guidance No 20/2004 (issued by the Ministry of Finance, TreasuryDirectorate) on the adaptation of the National Accounting Standards;
- Guidance No 14/2013 (issued by the Ministry of Finance, TreasuryDirectorate) on the application of the Public Sector Chart of Accounts and additional Guidance No 08/2014 regarding the reporting of specific operations, assets and liabilities when applyingthe Public Sector Chart of Accounts;
- Guidance by the Ministry of Finance No 05 from 2016 (issued by the Treasury Directorate) regarding depreciation of noncurrent non-financial assets of public sector entities;
- Guidance by the Ministry of Finance No 09 from 22 December 2020 (issued by the Treasury Directorate) regarding the year-end closing of accounts and presenting the annual cash-flow and turnover statements and other 2020 financial reporting information, and the publication of the 2020 annual financial statements of public entities
- 2020 Uniform Classifier of budget entities for the purpose of cash-basis accounting of operations, as approved by the Minister of Finance;
- Other guidance by the Minister of Finance issued in line with article 133, paragraph 5; article 167 and article 170 of the Law on Public Finances.

The public sector financial reporting framework in Bulgaria is regulated mainly by Chapter Fifteen - "*Budget Guidelines*" of the Law on Public Finances. The Minister of Finance **adopts accounting standards and a chart of accounts** and issues guidance for the public sector entities in line with:

- The requirements in effect in the European Union regarding public sector accounting, statistics and budgeting;
- The accounting framework, principles and concepts contained in the *Government Financial Statistics Manual* of the International Monetary Fund;

- International Public Sector Accounting Standards of the International Federation of Accountants;
- The requirements contained in the Bulgarian legislation regarding budgeting, reporting, budget execution and control of the funds and expenditure of public sector entities[2].

In 2020, Guidance No 20/14.12.2004 of the Minister of Finance regarding the application of **the National Accounting Standards** by public sector entities stayed in effect[3]**.** Between 2004 and 2021, the Treasury Directorate and the Municipal Finances Directorate of the Ministry of Finance issued a significant number of additional directions to supplement this fundamental guidance document for public sector financial reporting. The additional directions regulate various financial reporting issues, such as the Annual Uniform Budget Classifier; 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 ordered[5] **the continuation of the effect of Treasury Guidance No 20/2004 for public sector entities, *regardless of the repeal of the National Accounting Standards (NAS)*[6].** NAS ceased to apply only for 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 revision 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, accounting should be based on the concept of maintenance of financial capital. **This is in contradiction to the wide-spread understanding[8] that the main purpose of most public sector entities is rendering of public services rather than generating profit and return for the sake 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] laid down the requirement that public sector entities should draft and provide their annual financial statements based on public sector accounting standards developed in accordance with the International Public Sector Accounting Standards. Following the 2013 amendments to the Accountancy Act[10], the same requirement was introduced also through article 164 of the Law on Public Finances that entered into effect on 01 January 2014. **Nevertheless, to this point in time, no Public Sector Accounting Standards have been adopted officially in Bulgaria.**

The above-mentioned circumstances pose a number of challenges for the officials responsible for preparing the financial statements of public sector entities, as well as for financial auditors. **The guidance by the Minister of Finance introduces requirements related to specific provisions and concepts in the former NAS that were repealed 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 noncurrent tangible assets after recognition should be done in line with the provisions of item 7.1 (recommended approach) and 7.2 (possible alternative approach) 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 practices of public sector entities in such cases (although it is required to do so under the Law on Public Finances). There are other similar examples of insufficient guidance by the Minister of Finance, such as classification ofassets in the entries of the Public Sector Chart of Accounts; the application of cash basis of accounting for economic events, incl. capital expenditure; specific clarifications 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 Guidance No 20/2004 and item 21 of Treasury Guidance 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 basis principle[14] according to which the effect of transactions and other events should be recognized at the moment of their occurrence (regardless of the moment of receipt of the cash payments or their equivalents), and should be disclosed in the financial statements for the period of their occurrence. Reporting taxes on accrual basis is a challenge that has been identified at EU level in a number of analytical documents and a joint action has been planned.[15]**

Another example is the requirement set out in item 86 of Treasury Guidance No 7 from 2017 that as of 2018 a depreciation review should be carried out at least once every three years**.** In effect, this means **that public sector entities are not obliged to carry out annual depreciation reviews, i.e. to assess through the end of each reporting period [16] whether there are indications that the value of a specific asset has diminished and, if so, to calculate the asset’s recoverable amount. This is a prerequisite for non-compliance with the prudence principle[17] that requires evaluation and reporting of the probable risk and the possible expected losses in accounting business operation with the aim of disclosing 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 noncurrent non-financial assets** regulated by Treasury Guidance No 05/2016. In the process of auditing the 2017 annual financial statements, the National Audit Office identified[18] various **diverse practices of interpretation and application of these rules when the individual depreciation plan of an asset needs to be amended. Therefore,**

BNAO put forward the following recommendations to the Ministry of Finance:

- Clarify the definition of "depreciable amount" set out in item 9g of Treasury Guidance No 05/2016 by adding a sentence to the following effect: *„In case of changes in the depreciation schedule, the depreciable amount should be calculated as the difference between theasset's cost, its residual value and the accumulated depreciation."* or *„In case of changes to the depreciation schedule, the depreciable amount should be calculated as the difference between theasset's carrying amount and its residual value".* **The current definition of "*depreciable amount*" isnot sufficiently clear, because it fails to take into consideration the depreciation accumulated up to the moment when the asset's depreciation schedule was changed, which creates preconditions for error.** BNAO is of the opinion that the clarification of "depreciable amount" provided in the MF's *Comments on methodological issues* published at the end of 2019 simply restates the current definition and will not contribute to a better understanding.
- Laying down a clear requirement that in case of changes in the parameters of the depreciation schedule, 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;
- Specifying 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 when the depreciation schedule should be changed (e.g. month following the month of change; quarter; following reportingperiod).

Regardless of the fact that the going concern principle was part of the scope of the financial audits conducted prior to 2020, it gained greater importance following the introduction of the state of emergency on 13 March 2020. Definition of the going concern principle is provided in article 26, paragraph 1 of the Accountancy Act, however the relevant provisions of National Accounting Standard 1 are not applicable for public sector entities in line with item 7 of Treasury Guidance No 20 from 2004. Meanwhile, ISSAI 1570 sets out concrete responsibilities of the National Audit Office regardless of whether the financial reporting framework contains specific requirements or simply introduces the going concern principle. This is why, BNAO informed the Ministry of Finance and the audited entities of its responsibilities for auditing the going concern principle. The effect of the COVID -19 pandemic is therefore expected to be disclosed in the 2020 Annual Financial Statements.

4. Acceptable public sector financial reporting framework

International Standard of Supreme Audit Institutions (ISSAI) 1210 - *Agreeing the Terms of Audit Engagements* outlines the requirements and guidance relating to the auditor's judgment on **the acceptability of the financial reporting framework**. For the purpose of this judgment, BNAO takes into consideration factors such as the natureof public sector entities, 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 **only set of internationally recognized accounting standards[19] - the**

International Public Sector Accounting Standards of the International Federation of Accountants. The characteristic features that contribute to the usefulness of information and ensure the attainment of financial reporting goals are as follows[20]:

- **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 capability to continue rendering public services, attaining its goals, and ensuring access to the necessary resources.
- **Faithful representation –** it is attained through description of the economic and other events that is complete, neutral, and free from material misstatements. Omissions of information may mislead the users. Neutrality is important because the unbiased disclosures preclude the presentation of predefined results.
- **Understandability –** information should be presented in a way that corresponds to the needs and takes into consideration the users' level of competence. It is generally assumed that users have a reasonable understanding and knowledge of the functioning of the respective public sector entity and its environment, and that they are capable of understanding and analysing information contained in financial statements.
- **Timeliness** – it should be kept in mind that information might get obsolete before it is presented to the users.
- **Comparability** – disclosures should enable the identification of similarities and differences in the operations, processes, and performance of public sector entities. IPSAS stress that comparability is not a characteristic feature of separate information units, but rather refers to the correlation between these information units. Comparability should not be confused with consistency meaning the 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** – often associated with the requirement of enabling independent observers with different knowledge to reach a common agreement that the information presents the entity's operations and positions without any significant discrepancies and that the accounting methods for recognition, estimation or disclosure are applied free from errors or misstatements.

Compliance with the strict requirements of the internationally recognizedfinancial reporting framework is at risk in Bulgaria due to all the 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, which is set off by numerous general and specific accounting guidelines.

5. Future development of the public sector reporting framework

Bulgaria should take into consideration the global and European trends, and more specifically, the application of the International Public Sector Accounting Standards by a large number of countries and the attempts at introducing European Public Sector Accounting Standards (EPSAS)[21]. 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 member states' SAIs) informed of the EPSAS project development and the related debates.

Hypothetically, 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[22] in cases of discrepancies between the financial reporting framework and the sources of guidance for its implementation or conflicting positions in the sources concerning the financial reporting framework, by **giving priority to the most authoritative source.**

We recommend that the **financial reporting framework in Bulgaria be reviewed,** paving the way for the preparation for quick 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 in Bulgaria, BNAO adopted[23] a principle position regarding these standards that consists of several key elements**:**

1. BNAO supports **the full adoption of accrual basis accounting in the public sector.** This will ensure a foundation for adequate performance measurement and planning of public sector operations.
2. BNAO is in favour of 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. BNAO **supports the initiative for developing and introducing the EPSAS** that will contribute to improving the quality and transparency of public sector financial reporting and ensure better financial management of the public resources and debt.
4. BNAO **will support the efforts of the Ministry of Finance to modernize public sector accounting** and will continue to offer objective assessment of the development of financial reporting.
5. BNAO will **monitor the progress of the EPSAS project** taking into consideration the challenges relating to the transformation of the public sector financial reporting framework.
6. BNAO **will continue to participate actively in forums and events on the topic of public sector financial reporting**.

6. Audits of the 2020 Annual Financial Statements. Outcomes

In 2021, the Bulgarian National Audit Office continued to efficiently perform its audit functions in light of the new conditions following the outburst of the Covid-19 pandemic. It worked mainly remotely, relying heavily on e-communication tools, incl. for the purpose of obtaining audit evidence. The relatively easy adaptation to the new working conditions was due to the long years of experience using auditing software tools. All planned financial audits were completed successfully. BNAO's Board endorsed a total of 286 reports on the audits of the 2020 annual financial statements of public sector entities. The majority of issued audit opinions were unmodified, accounting for 85% of all audit opinions on the financial statements[24] *(see Figure 1).* This was mainly due to the fact that **audited entities were offered the possibility to revise the misstatements identified by the auditors in the course of the financial audits**. Such 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 that they **serve as a reliable basis for decision-making at institutional, regional and national level.** The significant 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 preconditioned on the nature of the financial reporting framework.**

In the past three years, there has been an increase in the number of modified audit opinions concerning municipalities (from 13 % in 2019 to 18 % in 2020), which accounts for the growing overall percentage of modified opinions. A key reason for this trend is the fact that the financial statements of municipalities managing smaller budgets (where the probability for misstatements is lower) are being audited in September-October, and therefore the possibility for corrections in the course of the audit is restricted. BNAO audits the financial statements of the nationally significant central government entities and municipalities in the period between March and July.

The increase in the number of expressed unmodified opinions is mainly due to the growing total number of financial audits of public sector entities.

Figure 1

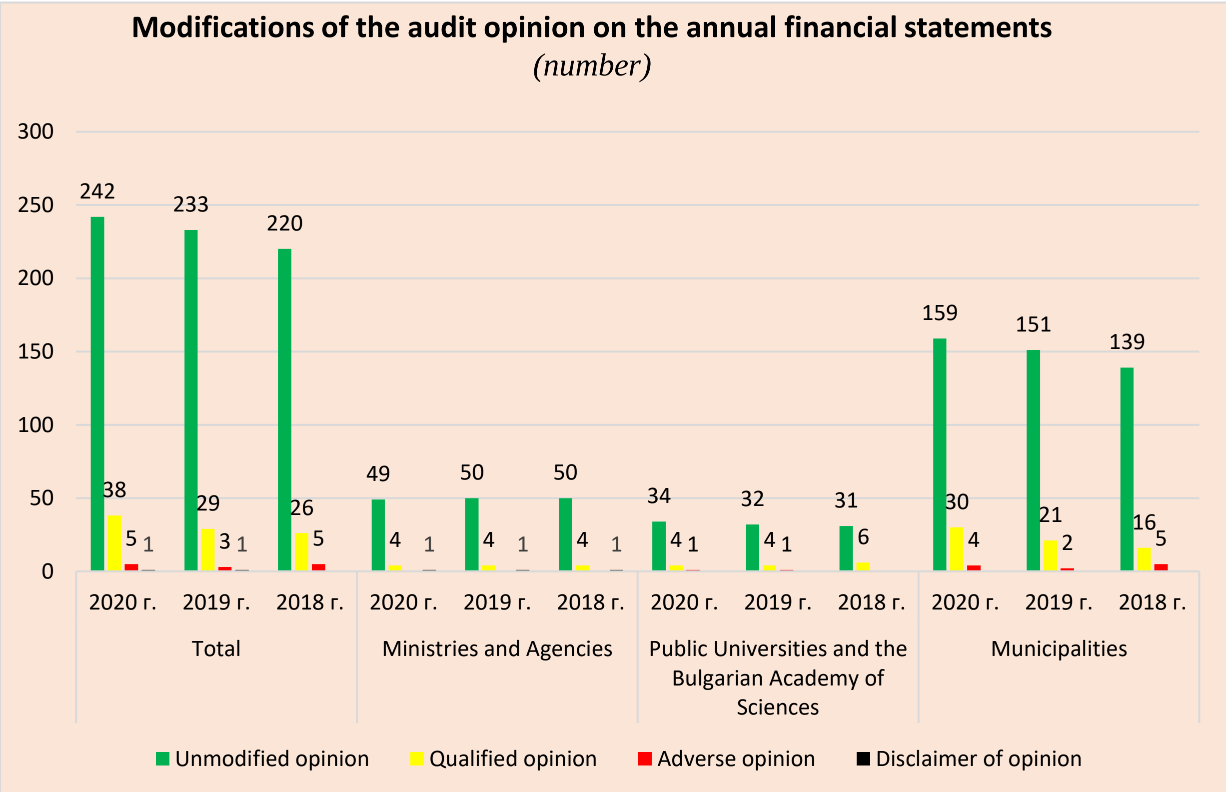


Figure 2

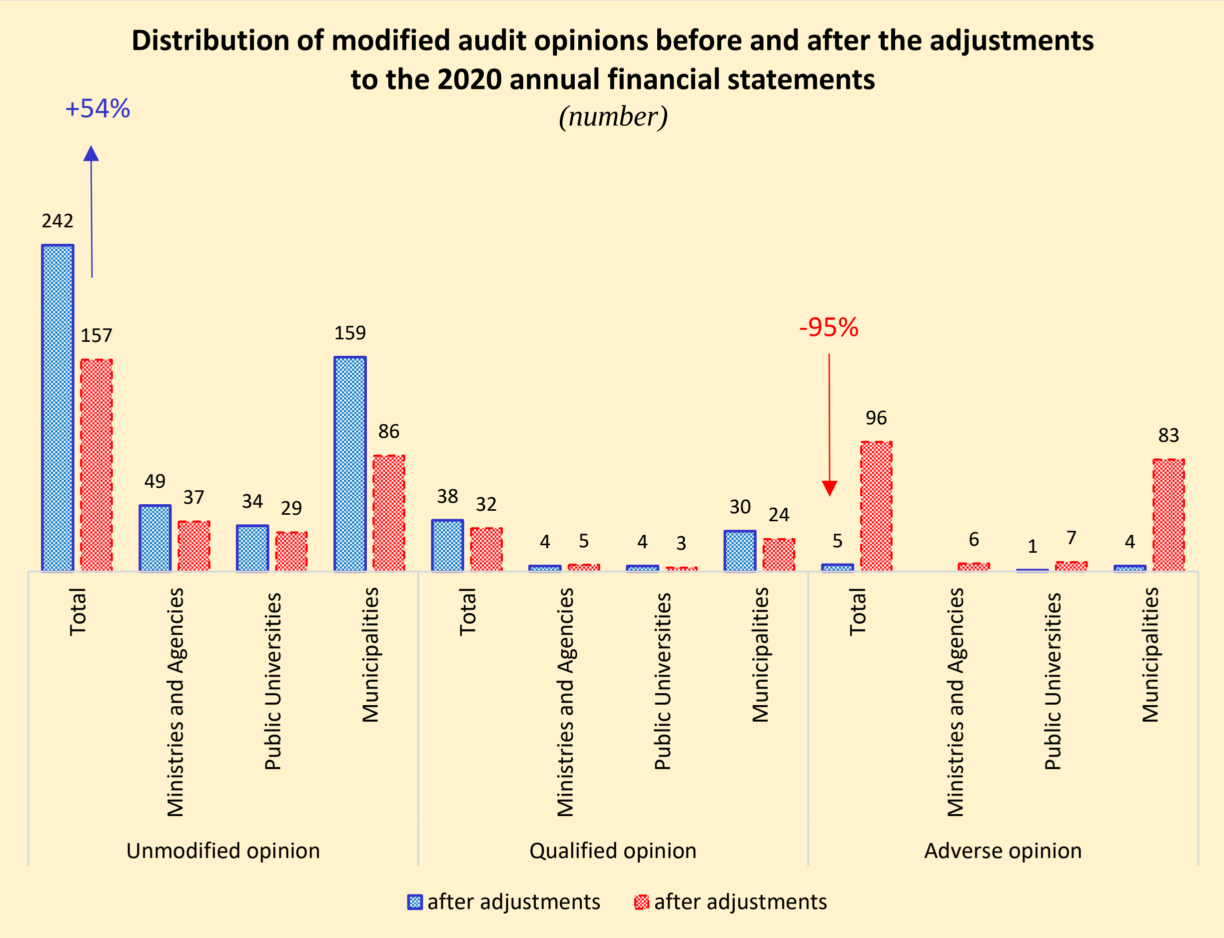


Fig. 2 demonstrates the **positive impact of the adjustments** [25] over the reliability of information presented in the annual financial statements. This is illustrated through the number of modificationsof the audit opinion in 2020. Had adjustments not been made, BNAO would have issued an **adverse opinion** on the financial statements of 96 public sector entities and a **qualified opinion** on the financial statements of 32 entities. **As a result of the adjustments in the course of the audits, the adverse opinions were reduced by 95 %, whereas the rate of unmodified opinions grew by 54%.** In other words, the adjustments of misstatements identified by BNAO resulted in increasing significantly 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 additional 73 unmodified opinions were issued (an increase by 85 %).

In formulating its audit opinion, BNAO determines the impact of each accounting error based on its occurrence in the annual financial statement. The occurrence of errors is preconditioned on the rules for financial reporting. The number of the error is not a determinant factor in itself. Certain errors do not affect the financial statements. They have a zero impact and are therefore not taken into consideration in formulating the audit opinion. Other errors have an impact on the amounts recognized in the financial statements and result in misstatements. One error may affect several financial statement entries and therefore result in more than one misstatement. A set of rules is applied to determine the impact of errors in the annual statements, such as:

- An entry recognized in the wrong group – misstatement in one of the two reporting groups;
- An error in both the cash and accrual basis disclosure – as many misstatements as are the number of affected entries in the annual financial statements;
- An error which affects both the Income Statement and Balance Sheet Statement – misstatements in both reports.

6.1. Systemic weaknesses identified in the course of financial audits of ministries, agencies and public universities

The following groups of errors and irregularities were identified recurrently and remained **unadjusted**:

- ***Miscalculation of depreciation costs*** following events that should lead to revision of the depreciation schedule (overhauls, etc.), and also as a result of manual entries of data in the depreciation schedule. This affects both the depreciation costs and the balance sheet value of noncurrent non-financial assets (also identified in the audits of the 2019, 2018 and 2017 financial statements).

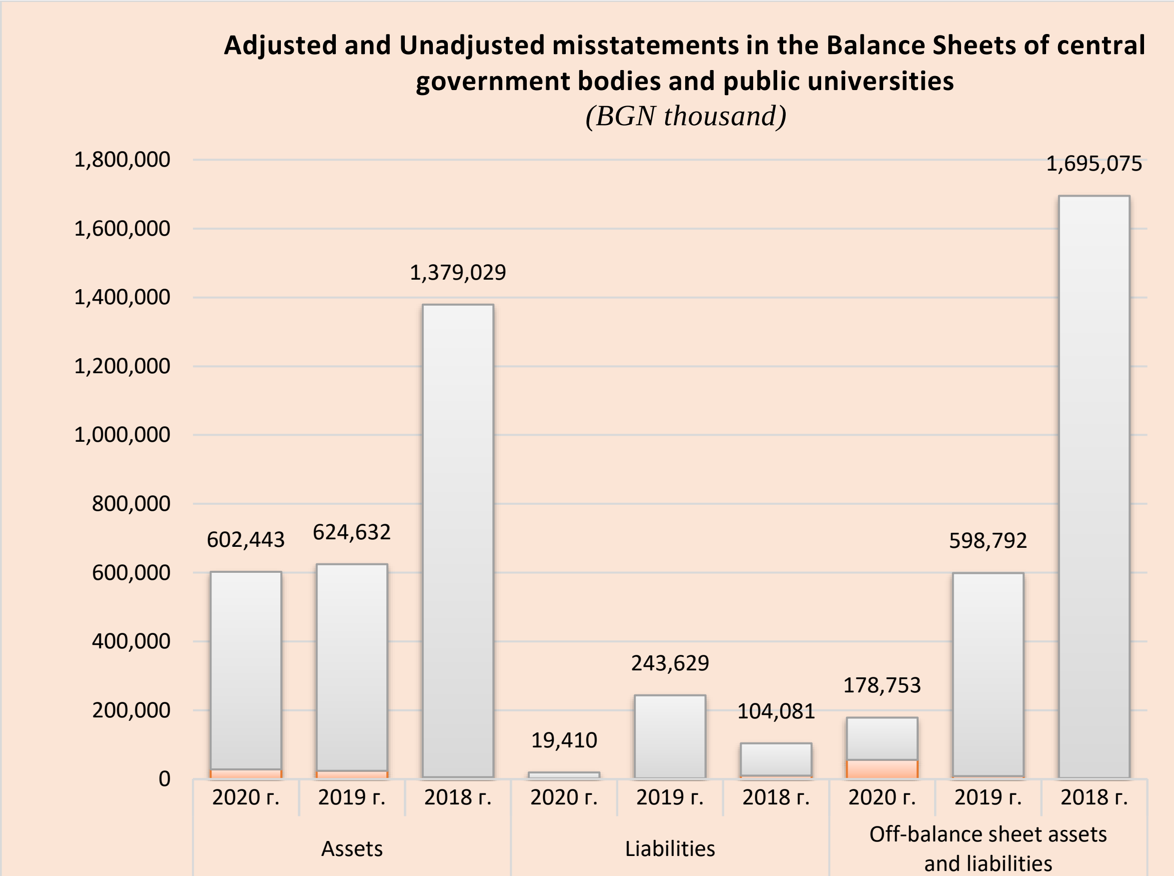
- ***Incorrect classification of assets, liabilities, revenues, expenses and transfers*** in the Public Sector Chart of Accounts and the Uniform Budget Classification (also identified during the 2019, 2018, 2017 and 2016 financial statements audits) resulting in misstatements in the balance sheet, income statement and budget execution statement.
- ***Incorrect reporting of bank guarantees and commitments*** (also identified in the course of the audits of 2019, 2018, 2017 and 2016 financial statements), resulting in under- or overstatement of off-balance sheet assets and liabilities.
- ***Misrepresentation of the changes in the shareholdings of public sector entities*** (also identified during the audits of the 2019, 2018, 2017 and 2016 financial statements). This results in misstatements in the annual financial statements of equity and related revenues.
- ***Incorrect recognition of advance payments*** as current-period expenditure (also identified during the audits of the 2018 financial statements), which results in understating of the public entity receivables for the respective period and overstating its expenditure.

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, such as:

- ✓ Adjustment of depreciation expense to ensure fair representation of the carrying amount of depreciable assets (also adjusted in the course of the audits of 2019 and 2018 financial statements.
- ✓ Recognition of undisclosed assets, liabilities, revenues and expense (also adjusted in the course of the audits of 2019, 2018, 2017 and 2016 financial statements). These adjustments ensured fair representation andfull disclosure in the financial statements.
- ✓ Correction of errors (mainly technical) in the Budget Execution Statement to ensure fair representation of the budget cash execution, the EU funds and third-party funds (also adjusted in the course of the audits of 2019, 2018 and 2017 financial statements).

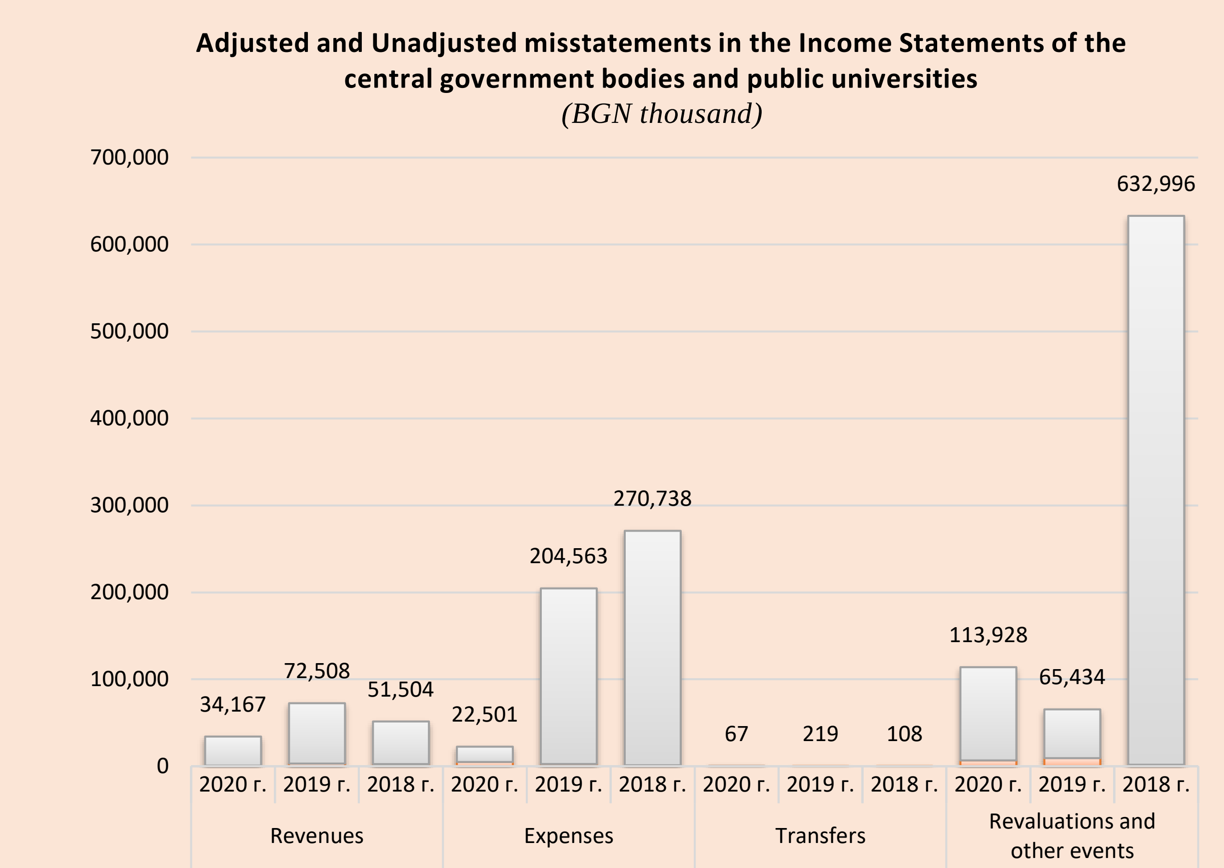
- ✓ Revising the classification of assets, liabilities, revenues, expenses and transfers in the Public Sector Chart of Accounts and the Uniform Budget Classification (also adjusted in the course of the audits of 2019, 2018, 2017 and 2016 financial statements), thus ensuring adequate disclosures in the Balance Sheet, Income and Budget Execution Statements.

Figure 3



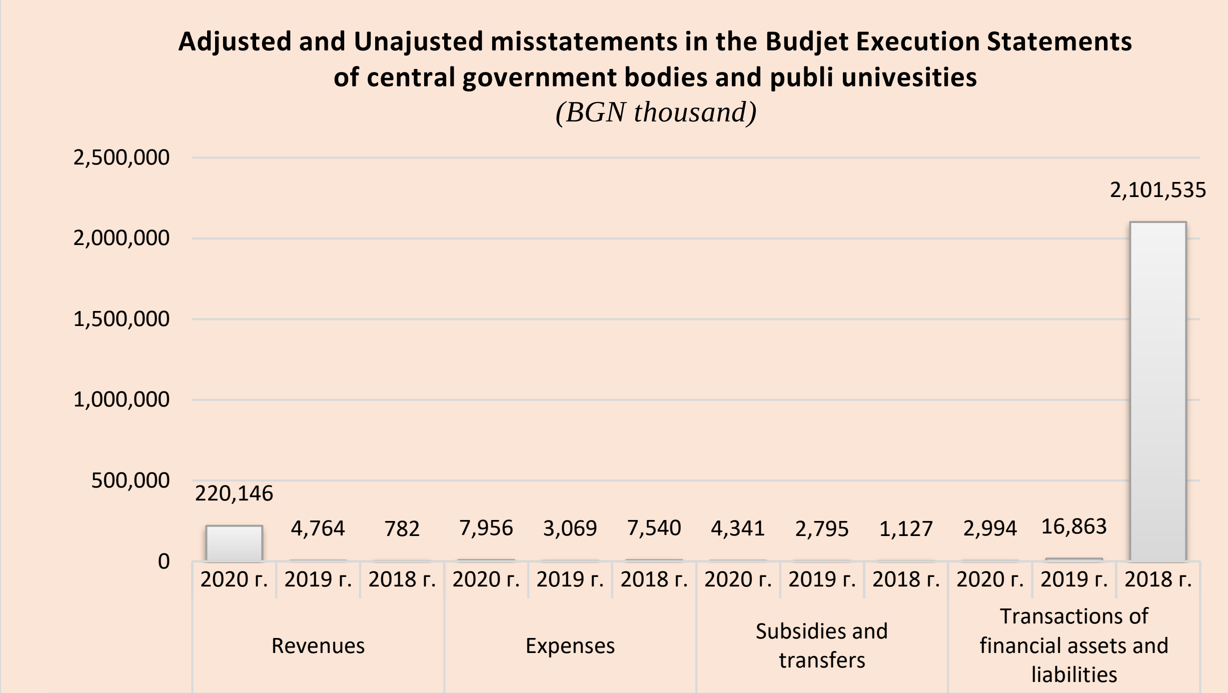
	Assets			Liabilities			Off-balance sheet assets and liabilities		
	2020 г.	2019 г.	2018 г.	2020 г.	2019 г.	2018 г.	2020 г.	2019 г.	2018 г.
Adjusted	574,105	600,374	1,373,418	17,456	241,379	93,903	122,713	590,046	1,692,062
Unadjusted	28,338	24,258	5,611	1,954	2,249	10,178	56,040	8,746	3,013
Total	602,443	624,632	1,379,029	19,410	243,629	104,081	178,753	598,792	1,695,075

Figure 4



	Revenues			Expenses			Transfers			Revaluations and other events		
	2020 г.	2019 г.	2018 г.	2020 г.	2019 г.	2018 г.	2020 г.	2019 г.	2018 г.	2020 г.	2019 г.	2018 г.
Adjusted	33,442	69,395	49,016	17,581	201,944	269,567	20	0	0	107,174	56,099	631,227
Unadjusted	725	3,113	2,488	4,920	2,618	1,171	47	219	108	6,754	9,335	1,769
Total	34,167	72,508	51,504	22,501	204,563	270,738	67	219	108	113,928	65,434	632,996

Figure 5



	Revenues 2020 г.	Revenues 2019 г.	Revenues 2018 г.	Expenses 2020 г.	Expenses 2019 г.	Expenses 2018 г.	Subsidies and transfers 2020 г.	Subsidies and transfers 2019 г.	Subsidies and transfers 2018 г.	Transactions of financial assets and liabilities 2020 г.	Transactions of financial assets and liabilities 2019 г.	Transactions of financial assets and liabilities 2018 г.
Adjusted	220,020	4,764	674	7,462	2,879	6,707	4,341	2,702	1,071	2,907	16,752	2,101,5
Unadjusted	126	0	108	495	190	833	0	93	56	87	111	29
Total	220,146	4,764	782	7,956	3,069	7,540	4,341	2,795	1,127	2,994	16,863	2,101,5

6.2. Systemic weaknesses identified during the financial audits of municipalities

The following recurring groups of errors and irregularities were identified in the financial statements of municipalities:

- Miscalculation of depreciation costs resulting from failure to update the depreciation schedules following a revision of the carried values, the initially determined useful life and the residual value of assets. Failure to perform depreciation of depreciable noncurrent non-financial assets and also to write off the accumulated depreciation of assets that have been sold or written off. Incorrect depreciation of noncurrent 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 the depreciation expenses and carrying values of noncurrent non-financial assets (also identified during the audits of the 2019, 2018 and 2017 financial statements).
- Incorrect classification of assets, liabilities, revenues, expenses and transfers in thePublic Sector Chart of Accounts and the Uniform Budget Classification (also identified during the audits of the 2019, 2018, 2017 and 2016 financial statements), which results in misstatements in thebalance sheet, income statement and budget execution statement.
- Misstatements of municipal shareholdings in commercial companies and failure to disclose the changes in them (also identified during the audits of the 2019, 2018, 2017 and 2016 financial statements) resulting in unfair representationof such investments and the related revenue.
- Absence of sock-taking of assets and liabilities, incl. costs for assets whose process of acquisition was pending during previous reporting periods (also identified during the audits

of the 2019 financial statements), indicating the incapability of internal controls to verify the information contained in the financial statements.

- Non-disclosed or misstated commitments (undertaken or implemented) and new liabilities, which usually results in understating of expenditure and balance-sheet and off-balance sheet liabilities (also identified during the audits of the 2019 financial statements).
- Incomplete disclosure of the current positions and changes regarding the assets, liabilities, revenues and expenditure thus precluding the financial statement users from making informed decisions (also identified during the audits of the 2019 financial statements).
- Incorrect reporting of changes to property deeds of municipal-owned estate recognized during earlier reporting periods. Recognizing municipal-owned estate at tax value rather than at fair value, oftentimes disclosing significantly lowered values, and thus understating of the assets.
- Misrepresentation of funds received and spent under EU-funded programs – transfers, advance payments and off-balance sheet statistical reporting at the expense of the beneficiaries, the EU and other donor organizations. This results in misstatements in the Balance Sheet, Income and Budget Execution Statements.
- Capital expenditure for construction works and overhauls of long-term tangible assets have not been recognized in the relevant accounts in accordance with the degree of completion of the works (respectively as assets and/ or construction in progress, production or overhaul) – also identified during the audits of the 2019 financial statements. Non-capitalized expenditure for acquisition and overhaul of infrastructure sites (also identified during the audits of the 2019, 2018, 2017 and 2016 financial statements) resulting in understatement of the value of these assets in the Balance Sheet, understating the depreciation costs and overstating expenditure capitalized under the item "*Other accounts and activities*".
- Incomplete or superficial reviews for impairment or revaluation of long-term assets. Inadequate approaches applied to the impairment reviews using the carrying value of the long-term assets for comparison purposes rather than their book value.
- Failure to report in the municipal financial statements the effect of contracts with water supply utilities under art 198o, paragraph 1 of the Law on Water. In some cases, the audits identified failure to report publicly owned assets transferred from the water supply companies to the municipalities. This results in misstatements in the Balance Sheet and Income Statements.
- Failure to provide accounting estimates of construction in progress, which usually results in understating the assets and overstating receivables.
- Absence of underlying documents for economic operations precluding the reliable corroboration of the values disclosed in the annual financial statements (also identified during the audits of the 2019 and 2018 financial statements.).

Without prejudice to the audit opinion, the reports on the annual financial statement audits of some municipalities contain emphasis of matter regarding the use short-term interest-free loans out of third-party accounts contrary to the legal provisions[26].

The audits identified some instances of non-compliance with the legal framework. Therefore, BNAO initiated procedures in line with article 57, paragraph 1 of the Law on the National Audit Office *(Figure 6)* and referred the cases to the relevant competent authorities (Public Financial Inspection Agency – regarding 65 municipalities[27] and the Prosecutor's Office – regarding one municipality[28]) for taking actions (also identified during the 2019 audits of annual financial statements). Some examples are:

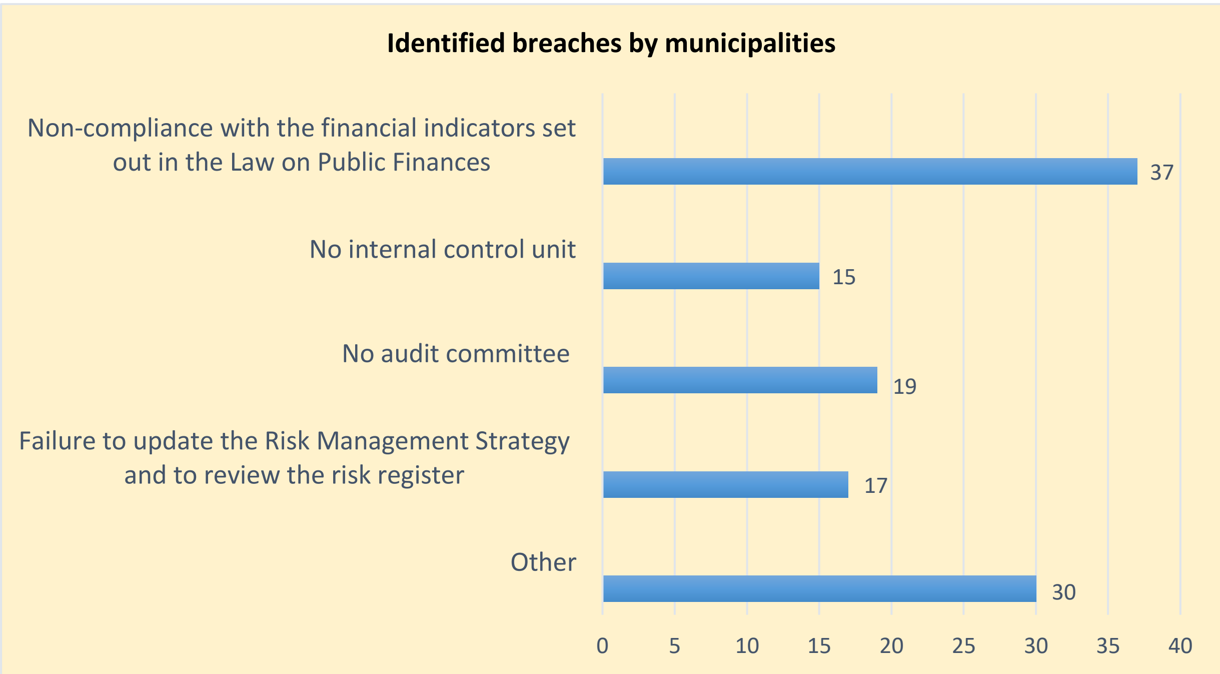
- Non-compliance with the financial indicators set out in the Law on Public Finances – regarding expenses, commitments for expenses and arrears under the Law on Public Finances, which is considered breach of the financial discipline in line with § 2 of the Supplementary Provisions of the Law on Public Finance.

- Absence of internal control units in line with article 12, paragraph. 2, item 3 of the Law on Public Sector Internal Auditing.

- Absence of audit committees in line with article 18, paragraph 1 of the Law on Public Sector Internal Auditing.

- Failure to ensure timely update of the Risk Management Strategy endorsed by the municipal mayor, which constitutes a breach of article 12 of the Law on the Public Sector Financial Management and Control. Failure to apply timely controls of the risk register in order to identify risks of potential events and circumstances that could have a negative impact on the attainment of the municipal goals.

Figure 6



In compliance with article 57, paragraph 1 of the Law on the National Audit Office, the Public Financial Inspection Agency keeps BNAO regularly informed of its ongoing financial inspections and their outcome.

Some of the errors and irregularities in the municipal financial statements **were adjusted** in the course of financial auditing:

✓ Adjustments of depreciation costs to achieve fair representation of the carrying value of depreciable assets (such adjustments were also introduced in the course of the audits of 2019 and 2018 financial statements).

✓ Adequate disclosure of the changes in the municipal shareholdings in commercial companies (also adjusted in the course of audits of the 2019, 2018, 2017 and 2016 financial statements) to achieve fair representation of the investments and the related revenue.

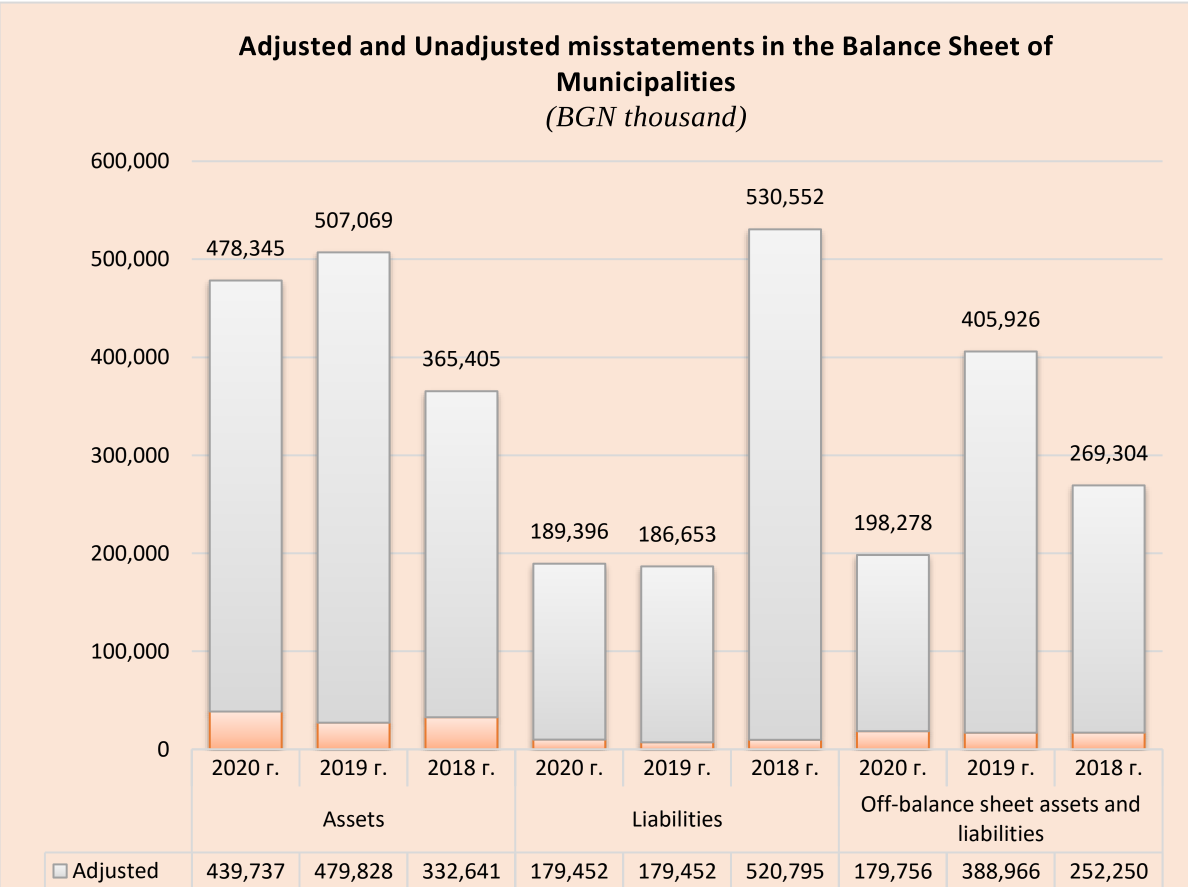
✓ Disclosure of commitments (taken and implemented) under contracts, bank guarantees, promissory notes, pledges on receivables or payables (also adjusted in the course of audits of the 2019, 2018, 2017 and 2016 financial statements). These corrections helped achieve fair representation and complete disclosure of off-balance sheet assets and liabilities in the financial statements

✓ Recognition of non-disclosed assets, liabilities, revenues and expenses (also adjusted in the course of audits of the 2019, 2018, 2017 and 2016 financial statements). These adjustments ensure fair representation and complete disclosure in the financial statements.

✓ Correction of errors (mainly technical) identified in the Budget Execution Statement and errors that occurred during the consolidation of the financial statements in the system of first-line budget organizations, the aim being to ensure fair representation (also adjusted in the course of the audits of 2019 and 2018 financial statements). In 2020, some 84% (accounting for 42,446 thousand BGN) of the misstatements of financial assets and liabilities transactions (see Fig. 9) were due to technical errors made by four municipalities in preparing their Budget Execution Statements.

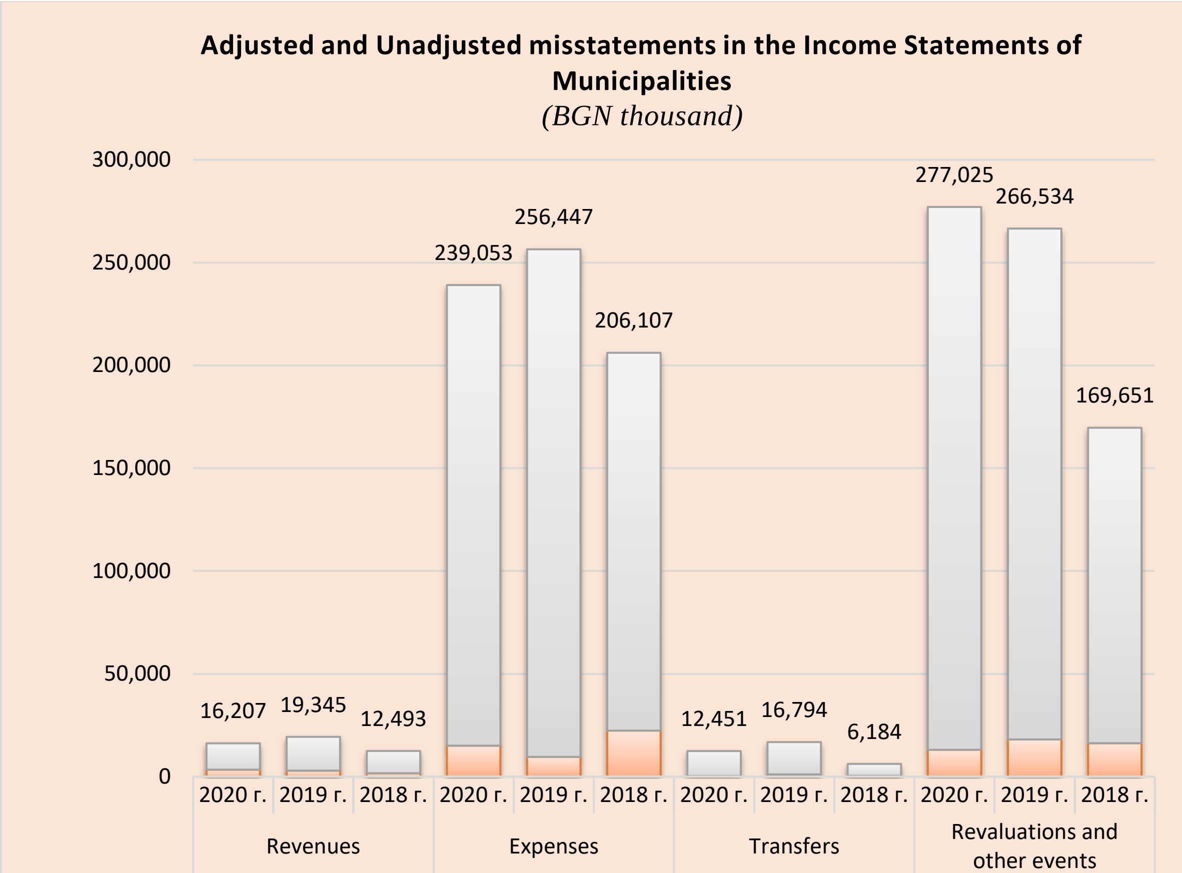
Adjusting the classification of assets, liabilities, revenues, expenses and transfers in the Public Sector Chart of Accounts and the Uniform Budget Classification (also adjusted in the course of audits of the 2019, 2018, 2017 and 2016 financial statements) resulting in correct representation in the balance sheet, income statement and the budget execution statement.

Figure 7



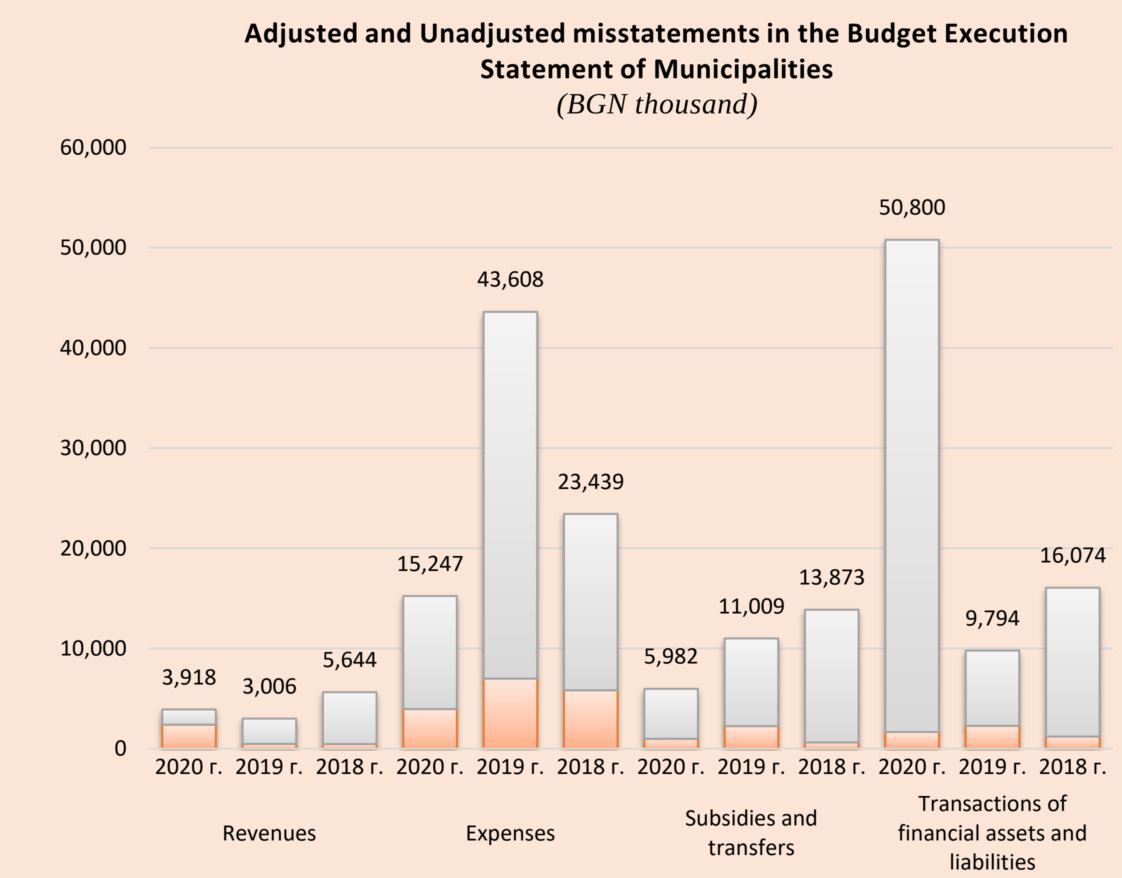
	Assets			Liabilities			Off-balance sheet assets and liabilities		
	2020 г.	2019 г.	2018 г.	2020 г.	2019 г.	2018 г.	2020 г.	2019 г.	2018 г.
Adjusted	439,737	479,828	332,641	179,452	179,452	520,795	179,756	388,966	252,250
Unadjusted	38,608	27,241	32,764	9,943	7,200	9,757	18,522	16,959	17,054
Total	478,345	507,069	365,405	189,396	186,653	530,552	198,278	405,926	269,304

Figure 8



	Revenues			Expenses			Transfers			Revaluations and other events		
	2020 г.	2019 г.	2018 г.	2020 г.	2019 г.	2018 г.	2020 г.	2019 г.	2018 г.	2020 г.	2019 г.	2018 г.
Adjusted	12,830	16,439	10,840	223,989	246,829	183,725	12,187	15,723	5,794	263,960	248,438	153,398
Unadjusted	3,377	2,906	1,653	15,063	9,618	22,382	264	1,071	390	13,065	18,096	16,253
Total	16,207	19,345	12,493	239,053	256,447	206,107	12,451	16,794	6,184	277,025	266,534	169,651

Figure 9



	Revenues			Expenses			Subsidies and transfers			Transactions of financial assets and liabilities		
	2020 г.	2019 г.	2018 г.	2020 г.	2019 г.	2018 г.	2020 г.	2019 г.	2018 г.	2020 г.	2019 г.	2018 г.
Adjusted	1,518	2,519	5,176	11,287	36,607	17,598	4,991	8,752	13,236	49,130	7,507	14,857
Unadjusted	2,401	487	468	3,960	7,001	5,841	991	2,257	637	1,671	2,286	1,217
Total	3,918	3,006	5,644	15,247	43,608	23,439	5,982	11,009	13,873	50,800	9,794	16,074

7. Main conclusions from the audits of the 2020 Financial Statements

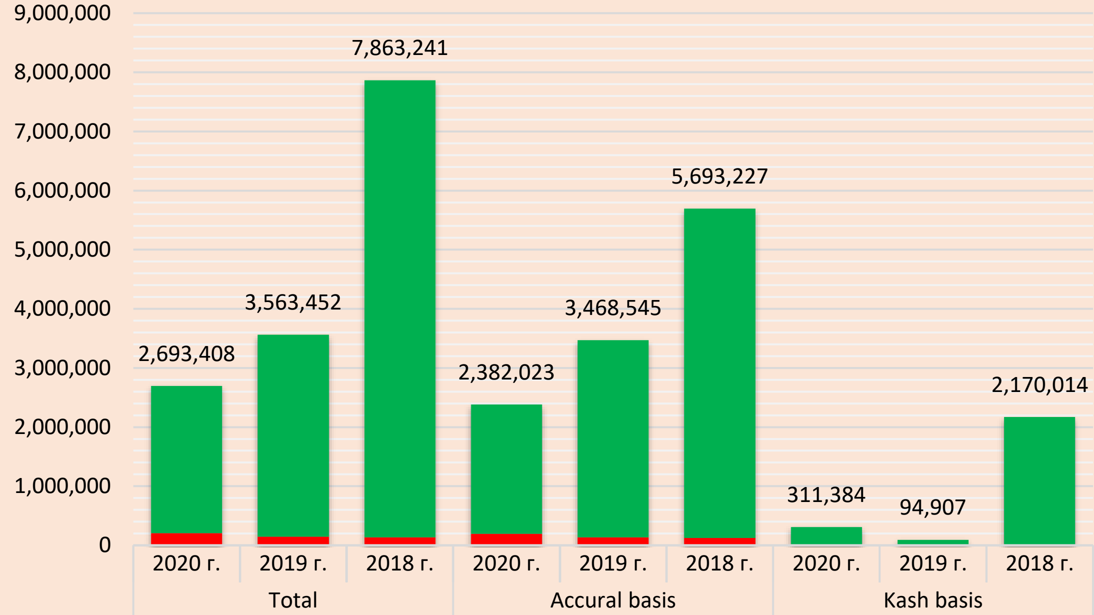
The corrections of errors in the financial statements of the public sector entities introduced as a result of the audits of the 2020 financial statements account for 2,49 billion BGN.

Some of the reasons for misstatements that remained unadjusted were:

- Differences of opinion between the auditors and the management of public sector entities regarding the accounting treatment and reporting of specific events, transactions and operations.
- Inability to introduce corrections of errors for previous periods that continue to impact 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 10

Misstatements in the Annual Financial Statements of Public Sector Entities
(thousand BGN)

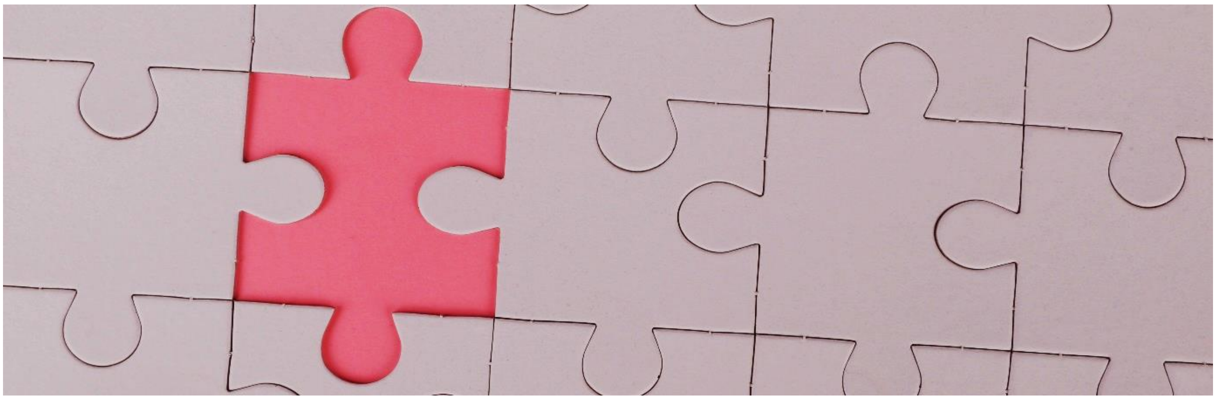


	Total			Accural basis			Kash basis		
	2020 г.	2019 г.	2018 г.	2020 г.	2019 г.	2018 г.	2020 г.	2019 г.	2018 г.
Adjusted	2,486,058	3,417,395	7,729,461	2,184,403	3,334,913	5,568,636	301,655	82,482	2,160,825
Unadjusted	207,350	146,057	133,780	197,620	133,632	124,591	9,729	12,425	9,189
Total	2,693,408	3,563,452	7,863,241	2,382,023	3,468,545	5,693,227	311,384	94,907	2,170,014

7.1. Weaknesses in the preparation of financial statements

- All three groups of audited public sector entities (central government bodies, public universities and municipalities) sometimes fail to **classify properly revenues and expenses, assets and liabilities in the relevant accounts of the Public Sector Chart of Accounts and respectively in the relevant paragraphs and sub- paragraphs of the Uniform Budget Classification.** In our opinion, the above misstatements are mainly due to the frequent amendments to the financial reporting framework, incl. insufficient and incomplete guidance on its implementation issued by the Ministry ofFinance (e.g. on recognizing adjacent land and facilities, classification of certain groupsof 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.
- Non-compliance with the MF guidance regarding the obligation to **perform reviews for impairment of noncurrent assets.**
- 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.
- Difficulties in identifying and applying the relevant principles in the Accountancy Act.

The above weaknesses in the financial reporting were also identified in auditing the 2019, 2018 and 2017 financial statements.



7.2. Weaknesses regarding the organization of the accounting process

- The highest relative share of modified opinions (qualified and adverse) is contained in the audit reports on the municipal annual financial statements. This is an indication of **insufficient administrative capacity** at municipal level.
- **Audited public sector entities** are not required to set up **an adequate uniform electronic database** of all accounting records (both accrual and cash basis) in the system of the first-line budget spending entities**.** The use of a uniform database when compiling the financial statements will reduce the risk of technical error in summarizing information; it will provide an **audit trail,** and **will remove the limitations on the scope of the computer-based audits**.
- **Inefficient internal controls** of the first-line budget spending entities concerning the accounting and budget discipline of their subordinate entities.

All weaknesses in the organization of the accounting process listed above were also identified in auditing the 2019 and 2018 financial statements, while the first two of them were also identified in the 2017, 2016 and 2015 financial statements.

8. Conclusion

The benefits of good public sector financial reporting are manifold – satisfying 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 aconstant 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 regard, while at the same time providing an objective assessment of the current state of play.

Annex 1

List of Municipalities and their relevant breaches reported to the Public Financial Inspection Agency in line with art. 57, paragraph of the Law on the National Audit Office in 2021

Municipality (name)	Non-compliance with the financial indicators regulated in the Law on Public Finances– re: expenditure, committed expenditure and arrears under the same Law in line with § 2 of its Supplementary Provisions	Absence of an internal control unit under article 12, paragraph 2, item 3 of the Law on Public Sector Internal Auditing	Absence of an Audit Committee under article 18, paragraph 1 of the Law on Public Sector Internal Auditing	Failure to ensure timely update of the Risk Management Strategy in violation of art. 12 of the Law on the Public Sector Financial Management and Control. No timely review of the risk register.	Miscellaneous
Aytos		non-compliance			
Ardino		non-compliance		non-compliance	non-compliance
Assenovgrad					non-compliance
Bansko	non-compliance				non-compliance
Belovo	non-compliance				
Blagoevgrad	non-compliance				
Botevgrad	non-compliance				
Bratsigovo					non-compliance
Burgas			non-compliance		
Velingrad	non-compliance				non-compliance
Gurkovo				non-compliance	
Garmen				non-compliance	non-compliance
Dospat	non-compliance				
Elin Pelin	non-compliance	non-compliance	non-compliance	non-compliance	
Elhovo		non-compliance	non-compliance		
Zemen				non-compliance	non-compliance
Zlatograd					non-compliance

Ivaylovgrad	non-compliance	non-compliance		non-compliance	non-compliance
Kameno		non-compliance	non-compliance		non-compliance
Karnobat			non-compliance		
Koprivshtitsa				non-compliance	
Kostenets	non-compliance	non-compliance			non-compliance
Kostinbrod	non-compliance				
Kotel		non-compliance			non-compliance
Kardzhali	non-compliance				non-compliance
Lessichovo	non-compliance			non-compliance	non-compliance
Lyubimets		non-compliance		non-compliance	
Malko Tarnovo	non-compliance				non-compliance
Maritsa	non-compliance		non-compliance		
Maglizh				non-compliance	
Nessebar	non-compliance				non-compliance
Nova Zagora			non-compliance	non-compliance	
Pavel Banya					non-compliance
Pazardzhik	non-compliance				non-compliance
Panagyurishte			non-compliance		
Pernik			non-compliance	non-compliance	
Perushtitsa	non-compliance				non-compliance
Peshtera			non-compliance		non-compliance
Primorsko	non-compliance		non-compliance		
Radomir				non-compliance	non-compliance
Rakovski			non-compliance		non-compliance
Rodopi					non-compliance
Rudozem	non-compliance				
Sandanski	non-compliance		non-compliance	non-compliance	
Satovcha	non-compliance				
Septemvri	non-compliance				
Simitli	non-compliance				
Sliven	non-compliance				
Smolyan	non-compliance				non-compliance

Sredets	non-compliance	non-compliance	non-compliance		non-compliance
Stara Zagora			non-compliance	non-compliance	
Stamboliyski	non-compliance		non-compliance		
Straldzha	non-compliance	non-compliance			
Sungurlare	non-compliance	non-compliance			
Tvarditsa	non-compliance	non-compliance	non-compliance	non-compliance	
Topolovgrad		non-compliance			non-compliance
Tundzha	non-compliance		non-compliance		
Haskovo					non-compliance
Hissarya	non-compliance				non-compliance
Tsarevo	non-compliance	non-compliance			
Chelopech	non-compliance				
Chepelare	non-compliance				non-compliance
Chirpan	non-compliance			non-compliance	
Yakoruda	non-compliance				
Yambol			non-compliance		non-compliance

[1] For example, when the audited entity's management refuses or is unable (due to reasons outside of its control) to provide the auditors with specific information.
[2] Law on Public Finances, article164
[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 12from 2001, SG 22 and 97 from 2002, repealed with Council of Ministers Decree No 46 from 21 March 2005 effective as of 01 January 2005.
[4] Here are some 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 the accounting of EU funds by the central government and municipalities contained in Guidance 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 long term non-financial assets in Public Sector Entities contained in letter No 05 from 30 September 2016 of the Treasury Directorate, MF.
- Guidance on the deadlines for stock-taking in public sector entities contained in letter No 10 from 28 December 2017.

[5] Guidance No 08 of the Treasury Directorate, MF dated 28 June 2005, item 30
[6] Council of Ministers Decree No 46 from 21 March 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
[9] Article 23, paragraph 4 of the Accountancy Act (repealed) in effect from 01 January 2002 through 31 December 2004; article 5a, paragraph 3 of the Accountancy Act (repealed) effective from 01 January 2005 through 31 December 2013.
[10] Amended - SG issue 15 from 15 February 2013.
[11] Treasury Guidance No 20 from 2004, item 16.23
[12]SG issue 86 from 2007 in effect as of 01 January 2008.
[13]Article 26, paragraph 1 of the Accountancy Act effective as of 01 January 2016.
[14] Article 26, paragraph 1, item 4 of the Accountancy Act effective as of 01 January, 2016.
[15] EUROSTAT, Ernst & Yong, 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] 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.*
[17] Article 26, paragraph 1, item 3 of the Accountancy Act effective as of 01 January 2016.
[18] 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.
[19]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

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

[22] ISA 200 - Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing, paragraph A5
[23] BNAO Decision No 166 from 15 June 2017
[24] Compared to other Supreme Audit Institutions in the EU, 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 2016 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 %.

[25] 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 taking into consideration the potential number of disclaimers of opinion. Each of these factors alone provides additional grounds for opinion modification. Therefore, if the above effects are taken into consideration, the number of modifications would grow. Consequently, in analysing the effect of adjustments, one should take into consideration the fact that the above situation describes the best-case scenario.

[26] 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.

[27] Annex 1

[28] Municipality of Lessichovo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