

# REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC) Moldova

## ACCOUNTING AND AUDITING

June 28, 2004

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### Executive Summary

Financial reporting and auditing practices in Moldova's corporate sector are currently in a period of transition from providing for tax calculation and statistical needs to convergence with International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA). This report draws upon recent international experience in developed economies and EU accession countries as well as expected amendments to EU Directives.

The National Accounting Standards (NAS) were developed on the basis of International Accounting Standards (IAS) from 1996 to 1998 for the most part, but they are substantially incomplete and out of date vis-à-vis IFRS (which incorporate IAS). Accordingly, the standard-setting process should be streamlined so as to allow the prompt adoption of the numerous existing IASs not yet reflected in the NAS. The National Standards of Auditing were developed recently and mirror ISA.

The existing Accounting Law and certain aspects of the Joint Stock Companies Law are unduly onerous and restrictive in that they demand bookkeeping and other administrative procedures not normally required in market economy systems. These conflict with mandated accounting standards, confuse the preparers of financial statements and are detrimental to the quality of the financial information. A new Accounting Law should be passed with simplified requirements and incorporating key elements of the NAS and relevant EU Directives on that matter.

There is a lack of transparency in the reporting systems, which do not have a registry to allow interested parties to view the companies' financial statements.

Strengthening financial reporting will also require improving education and training in the field of accounting and auditing. It will also depend on active enforcement on the part of regulatory agencies. In that regard, the review found that, except in the banking sector, the current level of compliance with financial reporting obligations is inadequate, and that the quality of the financial reporting is low. In that context, the report recommends the following actions: (i) the capacity of regulatory agencies for enforcing accounting standards and financial reporting requirements to all entities of public interest—including large state-owned enterprises—should be increased; (ii) a public registry should be set-up for all public-interest companies to file their financial statements; and (iii) an independent oversight board of auditors should be established under the soon-to-be-issued new Audit Law, with the function to qualify statutory auditors, adopt auditing standards and develop guidelines, and monitor auditors compliance with NSA and independence requirements.

A table summarizing the policy recommendations arising from this ROSC is provided hereafter.

**CURRENCY: MOLDOVAN LEI (MLD)**

**1 US\$ = 12 MLD as of May 31, 2004**

**MAIN ABBREVIATIONS AND ACRONYMS**

ACAP	Association of Professional Accountants and Auditors
AFAM	Association of Audit Firms of Moldova
CIS	Commonwealth of Independent States
CFAA	Country Financial Accountability Assessment
CNVM	National Securities Commission
FDI	Foreign Direct Investment
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Auditing Standards
GDP	Gross Domestic Product
IAASB	International Auditing and Assurance Standards Board
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IES	International Education Standards for Professional Accountants
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
ISA	International Standards on Auditing
JSC	Joint-Stock Company
LFI	Law on Financial Institutions
MoF	Ministry of Finance
MSE	Moldova Stock Exchange
NAS	National Accounting Standards
NBM	National Bank of Moldova
NSA	National Standards on Auditing
ROSC	Reports on the Observance of Standards and Codes
SME	Small and Medium Enterprises
SIIS	State Inspectorate on Insurance Supervision
SOE	State-Owned Enterprises
USAID	United States Agency for International Development

SUMMARY OF POLICY RECOMMENDATIONS				
Action	Responsibility	Timing		
		Short-term (less than 1 year)	Medium-term (1 to 3 years)	Long-term (3 to 5 years)
1. The Accounting Law should be thoroughly revised	MoF		x	
2. Adopt available Romanian and Russian translations of the all IFRS standards that have not yet been reflected into NAS and revise existing NAS for better alignment with IFRS	MoF	x		
3. Amend NAS 4, Accounting for Small Business Entities, to provide SMEs with a comprehensive reporting framework	MoF	x		
4. Require public-interest entities to file their annual financial statements with a public registry of companies, to be established possibly under the National Securities Commission (CNVM)	MoF / CNVM		x	
5. The JSC Law, State Enterprise Law and Law on Enterprises should be amended to require statutory financial statement audits in all public interest entities	MoF / CNVM		x	
6. Clarify the role of the Censors' Committee with respect to the financial reporting process and restrict the obligation to have Censors to entities not subject to statutory audits	MoF / CNVM		x	
7. CNVM's and SIIS's powers and capacity for enforcing accounting standards and financial reporting requirements should be strengthened	CNVM and SIIS (in their respective areas of purview)	x		
8. Finalize the draft of a new Auditing Law	MoF	x		
9. Establish an independent Audit Oversight Council	MoF, NBM, CNVM		x	
10. Academic curricula in the field of accounting and auditing, as well as professional education and training should be strengthened.	MoF, Ministry of Education		x	

## I. BACKGROUND

1. This assessment of accounting and auditing practices in Moldova is a 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 focuses on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting. International Financial Reporting Standards<sup>1</sup> (IFRS) and International Standards of Auditing<sup>2</sup> (ISA) have served as benchmarks for the assessment, which involved a review of both mandatory requirements and actual practice and drew on relevant international practices in the field of accounting and auditing regulation.

2. **With a gross domestic product (GDP) per capita of approximately US\$ 460, Moldova is one of the poorest countries in Europe.** Moldova's population is 4.3 million. A significant number of citizens live abroad, mainly in the European Union (EU), and their remittances represent a substantial source of revenue for the economy.<sup>3</sup> The country is heavily indebted and its economic development has been hampered over the recent years by an unstable political environment. Agriculture is still the dominant sector, accounting for about 30% of GDP. Inflation which used to be high, diminished dramatically from 39% in 1999 to 4.4% by the end of 2002; since then, it has risen to 15.7% in 2003 and latest forecasts point to a stabilization in 2004 around 8%. State-owned enterprises (SOE) play an important part in the economy, covering various sectors including agriculture (tobacco, wine), utilities and infrastructure (water, telecommunications), and various manufacturing and services industries (air transportation, electronic printing, etc.). The country's three largest enterprises are state-controlled. Transparency in, and oversight of, the SOE sector has been traditionally a concern in Moldova as in other transition economies.

3. **Moldova's financial system is dominated by the banking sector, with capital markets still at an early stage of development and playing a marginal role in the economy at present.** There are currently 25 companies listed on the Moldova Stock Exchange (MSE), with very low levels of trading.<sup>4</sup> Only two listed companies are represented among the top 100 companies in the country. The MSE was established primarily to enable trading in the shares of privatized companies that, following the mass privatization program, were partially privatized to Moldovan citizens.<sup>5</sup> Although the size of the stock market is currently quite small and trading is still relatively low, the role of the stock market can be important for the consolidation of ownership in the private sector, which in turn can help support the country's economic

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<sup>1</sup> IFRS correspond to the pronouncements issued by the International Accounting Standards Board (IASB) and International Accounting Standards (IAS) issued by its predecessor, the International Accounting Standards Committee (IASC), as well as related official interpretations.

<sup>2</sup> Issued by the International Auditing and Assurance Standards Board (IAASB) within the International Federation of Accountants (IFAC).

<sup>3</sup> The average annual yearly remittance flow from citizens working abroad is estimated to be between US\$460 million and 1 billion depending on the sources of information.

<sup>4</sup> Total market capitalization is estimated at MLD 800 million (equivalent to US\$ 70 million, or 3.5% of GDP) approximately (this data may not be fully meaningful as the majority of listed companies have not been traded for a long period of time, sometimes for several years; nonetheless the fact remains that the local stock market is of marginal importance).

<sup>5</sup> There are also over 1,000 joint-stock companies that are registered and available for trading on an off-the-exchange section of the securities market (equivalent to a sort of over-the-counter (OTC) section of the stock market). These companies are not listed and are subject to less strict requirements than those of listed companies. They were created through the issuance of privatization vouchers to the public. However, this off-the-exchange market currently involves very small transactions and does not appear to have any significant impact on the economy.

development. The banking sector is made up of 16 financial institutions, a majority of which have foreign shareholders, owning reported total assets of MLD 10 billion (equivalent to US\$ 800 million). The insurance sector is relatively small, comprising 50 companies with earned gross premium of MLD 290 million in 2003 and total assets of approximately MLD 200 million (US\$ 17 million) at the end of that year.

4. **The recent years have witnessed Moldova's growing integration with western and central European countries and with Romanian, which makes the EU economic and legal models all the more relevant to Moldova.** Since its independence in 1992, the Republic of Moldova has sought to develop relationships with its neighboring countries to the west, while keeping strong ties with fellow members of the Commonwealth of Independent States (CIS). Although most of Moldova's foreign trade is with other CIS countries,<sup>6</sup> the influence of Romania, with which Moldova shares the same language<sup>7</sup> is growing, especially in light of Romania's accelerated integration with the EU which is expected to culminate with accession in 2007. As for Moldova itself, while there is no consensus at present on EU membership as an objective for the country, there is a clear sense among the leadership of the economic benefits of aligning the country's regulations and standards with those of current or future EU countries.

## II. INSTITUTIONAL FRAMEWORK

### A. Statutory Framework

5. **The legal framework for corporate<sup>8</sup> accounting, financial reporting and auditing is provided in three main pieces of legislation that are largely outdated.<sup>9</sup>** The law is fully documented and tends to be prescriptive by setting out methodologies for conducting business. The three critical laws governing accounting, reporting, and auditing are (a) the Joint-Stock Company (JSC) Law; (b) the Accounting Law which dictates accounting policies and methods for maintaining the books of accounts; and (c) the Auditing Law which deals with auditing standards, qualification and licensing. In addition to this main body of legislation, banks, insurance companies, and listed companies are subject to specific requirements set out in the Securities Market Law, the Law on Financial Institutions (LFI), the Insurance Law, and the National Securities Commission Law, respectively.

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<sup>6</sup> In 2003, the CIS accounted for 52% of exports (of which 39% for Russia alone), while the shares of Romania and EU countries (including recent members) in Moldova's exports were respectively 11% and 25%.

<sup>7</sup> Romanian is the official language of the Republic of Moldova together with Russian. A majority of citizens use the Romanian language. Most practicing accountants use Russian as working language however.

<sup>8</sup> By corporate entities it is referred to enterprises of any size, owned either by the state or by private interests, and that do not belong to the financial sector (e.g., banking, insurance, brokerage, and investment management).

<sup>9</sup> It is difficult to identify the "legal tradition" to which Moldova belongs, mainly because Moldova was part of Romania before its incorporation into the Soviet Union in 1945, and shared the Roman Law based statutes and legal traditions that Romania still has. The authorities of Moldova have chosen not to hinge on those prior statutes and tradition, and instead to draw upon a broad set of references from other jurisdiction (including the EU and the US) in developing new acts of law covering accounting and auditing matters. Consistent with that approach, this report attempts to develop recommendations taking into account the experience in that field of other countries—including some whose economy is in transition, e.g., Romania, the most recent EU members, etc.—insofar as it is deemed relevant to the characteristics and development objectives of Moldova.

6. **The JSC Law of 1996,<sup>10</sup> sets the requirements for the preparation, examination, approval, filing and publication of annual financial statements in joint-stock companies.** There are approximately 3,600 joint-stock companies, which account for the highest number of large-to-medium-sized business entities in Moldova. Joint-stock companies may either be “open” or “closed”, depending on the number of shareholders and the existence of restrictions on stockholders’ right to dispose of their shares. Year-end financial statements must be “checked and confirmed” by a Censors’ Committee, and then must be submitted for review and approval, together with the Censors’ report to the shareholders no later than 10 days before the annual general meeting (Articles 50, 56, 71 and 87). JSCs are no longer required to have their annual accounts audited. Shareholders owning 10% or more of the shares may request an audit, which they have to pay for.

7. **The Censors’ Committee examination mandated by the JSC Law cannot be construed as an independent audit.** Article 71 prescribes that the Censors’ Committee should “exercise control over financial and economic activities of the company”. Details of how censors are appointed and how they should operate are to be defined in the company By-laws. Censors, who are designated by the shareholders for periods of two-to-five years, can be company employees as long as they have non-executive functions and do not work in the accounting department. They must be qualified in the field of accounting, finance or economics. Article 72 of the JSC Law provides details on the activities of Censors but nonetheless their role is far less strictly defined than that of auditors, especially in the absence of detailed terms of operations comparable to auditing standards, and in effect this control mechanism does not provide similar assurance on the accuracy and reliability of the financial statement as an external audit.

8. **The Law on Accounting of 1995<sup>11</sup> sets detailed instructions on how enterprises are to keep books of accounts, and places little emphasis on the objectives and content of financial reporting.** The Law has 57 articles, most of which deal with how the accounting process should be organized and documented, and the forms to be prepared for reporting purposes. Article 15 addresses some of the basic principles of accounting, including the accrual basis of accounting (although the cash basis is permitted for small entities), and “stability of accounting policies”, but is silent on most of the fundamental assertions and principles that govern financial reporting under IFRS, such as occurrence and existence, completeness, disclosure, matching of revenues and costs, prudence, etc. Article 45 of the Law requires that all business entities use the calendar year as their fiscal year. These detailed and prescriptive requirements reflect a strong focus on tax collection as an objective of accounting—and indeed this objective is explicitly set forth in Article 3 of the Law. The Law gives enterprises little flexibility on the way to set-up the accounting and reporting process, accounting policies in a manner that would best fit their needs for business management purposes and reporting to shareholders, bankers, etc. In addition, the law does not allow the use of IFRS for preparing company financial statements.

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<sup>10</sup> Law no. 910-XIII of July 1996 as amended in 2000 and 2002. Chapter 16 of the JSC Law (Art. 87-88) specifically deals with *Accounting and Reporting* and Chapter 17 (Art. 89-90) provides for *External Control*.

<sup>11</sup> Law no. 426-XIII of April 1995. The law has not been substantially amended since it was first passed almost a decade ago.

9. **Small and medium-sized enterprises (SMEs) are subject to simplified accounting requirements.** Under Article 14 of the Accounting Law, business entities “can use simplified double entry accounting if the average annual number of employees, the annual values of net sales and the total balance sheet value do not exceed limits set by the Government”.<sup>12</sup>

10. **All corporate entities must apply the National Accounting Standards (NAS) issued by the Ministry of Finance (MoF) under Articles 9 and 14 of the Accounting Law.** Specific standards have been issued for use by small business entities (NAS 4 and NAS 62), or so-called “savings and credit associations” (NAS 63). A description of the standards and their degree of alignment with IFRS is discussed in section III of this report.

11. **Requirements for financial reporting by banks and other financial institutions are set-out in the Law on Financial Institutions (LFI) of 1995, related regulations issued by the National Bank of Moldova (NBM), and NAS 30, *Disclosures in Financial Statements of Banks and Other Financial Institutions*.** Under the LFI and related regulations, financial institutions must issue and submit financial statements to the NBM, within four months after year-end (i.e., by April 30). If the institution’s assets exceed MLD 20 million (equivalent to US\$1.7 million), those financial statements must be subject to an external audit.<sup>13</sup> They must also publish an abridged version of their balance sheet in a newspaper and make the financial statements available free of charge to the public upon request.<sup>14</sup> Moreover, they are subject to quarterly financial reporting and public disclosure, including on their financial statements, detailed information on loans and deposits and various financial ratios.<sup>15</sup> Financial institutions must apply the chart of accounts and accounting standards developed and approved by the NBM in coordination with the MoF, in accordance with Article 10 of the Law on Accounting. In preparing their annual accounts, financial institutions must comply with NAS, including NAS 30, *Disclosures in Financial Statements of Banks and Other Financial Institutions* (paragraph 36).

12. **Companies available for trading on the stock market and other open JSCs are required to issue an annual report under the Securities Market Law of 1995, although in fact such annual report the same as the financial statements required by the JSC law.** Under Regulation no. 18-5 of the National Securities Commission (CNVM) issued in 1995, the annual report merely contains a balance sheet and income statement, which are already required by the JSC law, together with miscellaneous information on the shareholding structure and material events.

13. **Companies listed on the Moldova Stock Exchange (MSE) may be subject to auditing and publication requirements under stock exchange regulations.** MSE Regulations set out the structure of the exchange into three tiers: (i) companies with a share capital in excess of MLD 4 million (approximately US\$300,000) and with 1,000 or more shareholders, which are required to have their annual financial statements audited by an international firm; (ii) companies whose

<sup>12</sup> Accounting Law, Article 14, paragraph 3. Government Decision no. 1476 of November 2002 set the following thresholds: 30 employees; MLD 3 million (US\$ 250,000) of annual net revenues and MLD 3 million of total assets. Paragraph 2 allows the use of single-entry accounting for businesses that employ only family members or whose turnover and total assets do not reach minima set by the Government.

<sup>13</sup> Other banks are subject to a verification by either an accounting professional or a bank accountant authorized by the NBM. According to the NBM, all banks in Moldova are currently above the MDL 20 million limit and are therefore subject to external audit.

<sup>14</sup> LFI, Article 35 and NBM’s Regulation on Procedures for the Preparation and Submission of Audit Reports – October 1997.

<sup>15</sup> NBM’s Regulation on Publishing Information on Financial Activity by Commercial Banks – December 2000. It should be noted that NBM’s regulations appropriately set forth the “Qualitative Characteristics of Transparent Information” (Section IV of the Regulation on Publishing)

share capital and number of shareholders are less than MLD 4 million and 1000, and in excess of MLD 2 million (approximately US\$150,000) and 500 respectively, which must have their financial statements audited; and (iii) the remainder of listed companies. Since most of the tier-one and tier-two companies are banks, which are already required to have their financial statements audited under the LFI, the MSE regulation does not have much impact. As a result, the financial statements of most enterprises in Moldova are not required to be audited under the current legislation.<sup>16</sup> The stock exchange imposes no specific requirement for audit other than that required by the Joint Stock Companies Law. It states that it makes no monitoring of the financial statements other than to ensure that they are received on time and have an audit report if required.

14. **Under the Law on Insurance of 1993, the State Inspectorate on Insurance Supervision (SIIS, a semi-autonomous entity under the MoF) and the Department of Statistics are responsible for establishing rules on how insurance companies should record their transactions and report on their activities.**<sup>17</sup> The insurance law requires companies to present their balance sheet and profit and loss statement within six months after year-end, “after confirmation of their authenticity through an *audit inspection*”.<sup>18</sup> Yet there is no explicit requirement for an external audit. The SIIS has made adaptations to the general, MoF-issued chart of accounts and has developed a standard reporting procedure that requires insurance companies to report their activities, including reinsurance, long-term premium reserves by insurance type, and calculation of solvency ratios. There is also a procedure of quarterly reports to be submitted to the SIIS.

15. **State-owned enterprises (SOEs) are not subject to any particular accounting, financial reporting and auditing requirements.** SOEs can be legally incorporated as JSCs or as “state enterprises” (when they are 100% controlled). The Law on State Enterprises is silent on the issue of financial reporting and auditing. No information is publicly available on SOEs’ financial position and performance.

16. **“Professional participants” on the stock exchange are subject to financial reporting and auditing obligations set in CNVM regulations.** The CNVM’s regulation and supervision is mostly geared toward so-called professional participants, who include brokerage firms, mutual funds, fiduciary company and auditors, all of whom must be properly licensed.<sup>19</sup> They must submit audited annual financial statements, in addition to periodic reporting on their operations and on their financial position and performance to the CNVM. Specific forms for financial reporting by investment funds and fiduciary companies have been set by the CNVM in 1995; these include compulsory disclosures on investment portfolio, remuneration, etc. The CNVM has licensed seven auditors to audit professional participants.

17. **Audit practice is governed by the Law on Audit Activities of 1996 which is in the process of being rewritten.** The law is comprehensive in its coverage, dealing with the objectives, scope and content of audits, the conditions for individuals or firms to qualify as auditors, the responsibilities of auditors, etc. A license is required to conduct audit activities in Moldova. Auditor licenses are awarded by the Licensing Chamber, on the basis of a certificate issued by the Qualification Commissions of either the MoF (for enterprises and insurance companies, the NBM (for banks), or the CNVM (for professional participants in the securities

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<sup>16</sup> Listing requires the filing of the last three years financial statements with the level of auditing requirement depending on the tier. No prospectus is required for initial or secondary public offerings.

<sup>17</sup> Law no. 1508-XII of June 1993 – Article 52.

<sup>18</sup> The language used in the law (“inspection”) reflects a focus on formal compliance and the fact that there was no clear definition of financial audit at the time the insurance act was passed in 1993.

<sup>19</sup> According to the CNVM, there are currently 109 professional participants.



market).<sup>20</sup> A new auditing law is being prepared by the MoF on the basis of the recommendations of the World Bank's Country Financial Accountability Assessment (CFAA) released in September of 2003. The shortcomings of current legislation that the new law would have to address include the following main points (see also Box 1 on a proposed new Auditing Law):

- The fundamental objectives of an audit of financial statements and the corresponding basic concepts as set in the existing law are not in line with ISA, EU legislation or other best practices—for instance, the very definition of an audit does not include the notions of reasonable assurance, true and fair view and responsibility of management
- Articles 4 and 6 of the Law deal with auditors' independence, professional conduct and conflicts of interest, but the requirements it sets on these issues are quite general. For instance, Article 6 prohibits an audit firm from "*performing any activities other than auditing*", which is meant to prescribe that audit firms should not engage in business activities that do not relate to accounting. On issues of incompatibilities and conflicts of interest, Article 4 lists various types of activities that an audit firm is authorized to undertake,<sup>21</sup> yet it does not set forth the underlying principles to be followed by auditors under any circumstance,<sup>22</sup> and is too general and imprecise on issues of financial interests in audited companies (it only forbids auditors from being owners of the company, which does not prevent them from having a significant interest in it).
- The principles for qualifying auditors are not set forth in the law; these would include the need for adequate academic background, minimum practical experience and a due process of qualification in accordance with the standards issued by IFAC, including a professional examination that would allow to test an auditor-trainee's competence and ability to exercise professional judgment.<sup>23</sup> The MoF regulations partly address these issues (see paragraph 27), but given their importance they should be dealt with in the new Law.
- The Law sets auditors' obligations but does not provide for a mechanism to monitor auditors' compliance with these statutory obligations.

18. **A professional ethics code has been developed on the basis of IFAC's Code of Ethics for Professional Accountants.** Through Order no. 29 of March 2001, the MoF has issued the *Code of Professional Conduct for Auditors and Accountants of Republic of Moldova* which became effective on January 1<sup>st</sup>, 2002. It is based on IFAC's code as amended in 2000, which was translated into Romanian with the assistance of the one of the local professional bodies, Association of Professional Accountants and Auditors (ACAP – see paragraph 21 hereafter) and the U.S. Agency for International Development (USAID).

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<sup>20</sup> See also paragraph 27.

<sup>21</sup> Services that an audit firm is authorized to provide are as follows: "assistance related to the organization, restoring and maintenance of accounting procedures, formulation of financial reports, fiscal declarations, estimation of financial situation, assessment of economic and financial activity, organizing computerized accounting systems, evaluation of assets, taxation and management, as well as legal assistance in economic and financial activities".

<sup>22</sup> Article 6, paragraph 2, prohibits audit being performed by individuals who have a family or business relationship with owners or members of management, or who provide certain services deemed incompatible ("assistance in organizing and maintenance of accounting, as well as in formulation of financial reports"—this definition is actually too narrow and should also include tax, human resource, and payroll advisory as well as any form of consulting services).

<sup>23</sup> International Education Standards for Professional Accountants (IES) no. 1 to 6 issued in 2003.

19. **Audits of banks and other financial institutions are regulated by the LFI and NBM's specific rules.**<sup>24</sup> Banks can only appoint an audit firm holding a license to audit financial institutions and whose staff have been awarded an auditing certificate by the NBM's Qualification Commission.<sup>25</sup> Audits must be carried-out in accordance with ISA and an engagement letter must be signed between the auditor and the bank. The NBM is entitled to remove the auditors and/or to repeal their auditing certificate when it considers that they do not comply with their statutory obligations.

20. **The current legislation and regulation do not provide for the availability of enterprises' financial statements to shareholders, creditors or other interested parties.** The Department of Statistics receives copies of all financial statements from JSCs and other business entities, for compilation of national statistics but is prohibited by law from disclosing the content of individual statements. Consequently, there is little transparency in the corporate sector, hence investors and bankers cannot obtain information on individual companies which they do not interact with. Comparative financial analysis which is a key element of credit assessment and investment decisions is therefore made difficult. Ultimately, this lack of information constitutes an impediment to the development of investing, lending and possibly commercial activities in the corporate sector, and contributes to increasing the cost of capital for enterprises.

## **B. The Accounting Profession**

21. **The public accounting profession in Moldova is still at an early stage of development and the audit practice still needs strengthening.** Audit activities have only been introduced and developed recently in Moldova—essentially in the second half of the 1990s. Moreover, because of the narrow scope of statutory audit requirement (paragraph 6) and the modest inflow of foreign investment, demand for audit and related services is relatively low. The Association of Professional Accountants and Auditors (ACAP), a not-for-profit organization established in 1996, is the profession's most representative body, with a membership of approximately 500—mainly individual accountants in small practice. Another professional organization, the Association of Auditing Firms of Moldova (AFAM) has a membership of some 30 local firms. ACAP and AFAM do not cooperate with each other, nor are they actively involved in the accounting and auditing standard-setting process and in the supervision of the profession.

22. **The market for the provision of audit services is split between two clearly distinct segments, one for statutory audits by local firms and the other for audits of banks, listed companies or enterprises with foreign shareholders provided by local affiliates of the "Big-4" international networks.** There are currently 117 audit firms or individual auditors authorized to conduct activities in Moldova, with some 500 employees. The six largest firms in the country by number of licensed staff account for approximately one-fourth of the workforce and number of licensed individuals. The majority of the Big-4 local affiliates only carry-out audits of banks or local subsidiaries or investees of international groups.<sup>26</sup> There does not appear to be a shortage of

<sup>24</sup> NBM Regulations on Procedures for the Preparation and Submission of Audit Reports (see above) and on Issuing Certificate for Qualification of Bank Auditor (no. 34/09-01).

<sup>25</sup> NBM's requirements to obtain an auditor certificate include: (i) having a university or college degree in the economic field; (ii) minimum experience working as auditor, accountant, supervisor, or professor in the banking field— three years of experience over the last five) years for university graduates and five years of experience over the last ten years for college graduates; and (iii) obtaining at least 7 grades out of 10 before an ad-hoc qualification commission appointed by the Board of the NBM (Decision of the NBM Board, October 1996).

<sup>26</sup> It is worth noting that those local Big-4 affiliates are managed by partners who are located outside of Moldova, mainly in Bucharest.

auditors at present. However, should the authorities decide to extend the statutory audit requirement to a wider array of entities as suggested hereafter (see paragraph 54), the supply of adequately skilled and trained auditors would have to be increased.

23. **ACAP has made commendable efforts to foster quality audit practice by encouraging members to seek certification from recognized international organizations and mandating such certification for its members who are auditors.** Upon its creation, ACAP admitted some 2,000 accountants as temporary members who had to subsequently pass an examination to obtain permanent membership.<sup>27</sup> ACAP requires its members to have three years of professional experience and to pass a written technical examination whose syllabus is based on a model developed at the level of the Commonwealth of Independent States (CIS). ACAP members are encouraged to seek certification by the Certified International Professional Accountant (CIPA) Program, a program established in 2001 by the USAID in cooperation with international standard-setters and various accounting organization from English-speaking countries.<sup>28</sup> According to ACAP, CIPA certification is a requirement for all members who are practicing auditors. ACAP, while not being a party to the accounting and auditing standard-setting process, contributes to the dissemination of the standards by proposing courses to its members. Also, in 1998, it released an English translation of NAS and the MoF-issued chart of accounts, and assisted in the translation of IFAC's code of ethics. ACAP has been an associate member of IFAC since 1998. These achievements have only been made possible by the financial support from international aid organizations, which is expected to diminish in the near future.

24. **AFAM is an organization of licensed audit firms acting as a trade association.** Under Article 9 of the current Auditing Law, AFAM is recognized as the body with wide responsibilities including coordinating the activity of audit firms, representing their professional interests, collaborating with counterpart foreign organizations, and developing auditing standards and qualification and examination programs to be approved by the MoF and submitting requests for the withdrawal of auditor certificates. In practice, these functions have not been effectively exercised. None of the local Big-4 member firms are members of AFAM.

25. **Various factors constrain auditors' accountability toward stakeholders.** First of all, audited information is seldom available to the public, which has the effect of reducing auditors' exposure to the consequences of possible non-compliance with auditing standards and professional obligations. In addition, auditors are not required to take out professional indemnity insurance, which are meant to facilitate financial statements users' recourse against errant auditors.<sup>29</sup> Furthermore, audit committees, whose role is to monitor external auditors' performance in fulfilling their duties to deliver an audit of quality, are infrequent among Moldovan companies. Added to the absence of enforcement of auditors' obligations by authorities or professional bodies, these factors create an environment of limited accountability that is not conducive to an audit practice of high quality.

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<sup>27</sup> Until 2003, a large number of ACAP members did not actively participate to the association and did not pay their annual membership fees. The decision was then taken at ACAP's annual general meeting in 2003 to expel those inactive members, thereby reducing the total membership to 500 approximately.

<sup>28</sup> Details on the CIPA Program are available on its website at [http://www.capcipa.biz/icaicp\\_eng/htm](http://www.capcipa.biz/icaicp_eng/htm). Moldovan candidates take examinations in Ukraine.

<sup>29</sup> Auditors are subject to civil and criminal liabilities under the law (Civil Code, Law on Auditing, etc.), although there have been no legal cases brought against auditors.


### C. Professional Education and Training

26. **Accounting education in Moldova needs strengthening.** The Academy of Economic Studies of Moldova is the main institution providing higher education in accounting. The “Accounting and Auditing” curriculum is comprehensive, including courses on NAS, international standards and sector-specific aspects. Yet, the audit content of the curriculum is quite limited (only two courses deal with audit), and some important courses especially in the context of Moldova are only optional, including *Accounting in small and medium enterprises* and *Formulation and presentation of financial statements*. A review of the syllabus of some of the courses indicate that they are adequate in terms of issues covered. The university experiences difficulty in improving the course contents and keeping syllabi up-to-date with international best practices and IFAC’s education standards due to lack of resources, which limit its capacity to purchase and translate relevant material. Moreover, the accounting curriculum does not contemplate apprenticeships within an accounting firm allowing students to apply their knowledge in actual situations and develop basic professional skills. Representatives of the leading accounting firms indicated in interviews that, while they recognized the quality of the Academy of Economic Studies’ graduates, they had difficulties in finding recruits with adequate skills and, for some of them, preferred hiring graduates from foreign universities. In any case, local member firms of the international audit networks require their staff to pass the certification examination issued by the ACCA (a professional accounting body based in the United Kingdom), and accordingly provide them substantial in-house training to prepare the exams.

27. **The professional examination required for the issuance of the auditor certificate does not comply in various aspects with related IFAC education standard.** The examination is conducted by a Qualification Commission appointed by the MoF. The one-day exam consists of either written or oral questions, at the choice of the candidates; on average, 70% of the candidates take oral questions. Questions can cover various subjects including legislative and normative acts, accounting and reporting, audit, taxation, and financial analysis. Based on interviews with auditors, the examination focuses more on academic and knowledge-related aspects than on issues involving the auditing practice and the judgment to be exercised by auditors in real-life circumstances. These arrangements conflict with IFAC’s International Education Standard (IES) 6, *Assessment of Professional Capabilities and Competence* —which states, *inter alia*, that the examination should “require a significant portion of the candidate’s responses to be in recorded form” and “cover a sufficient amount of the whole range of professional knowledge, professional skills, and professional values and the attitudes (...).” The examination results do not provide sufficient guarantees that the persons to whom the certificate is awarded have demonstrated adequate professional skills and values to carry-out the functions of independent auditor.

28. **Professional continuing education is not mandatory to retain a certificate of auditor and is only carried-out by audit firms whose internal policies set such requirements.** IES 7, *Continuing Professional Development (...)* prescribes that all members of the accounting profession should receive continuing education in order for them to be able to provide “high-quality services to meet the needs of the public”. Indeed continuing education is especially needed for auditors to keep their knowledge of applicable legislation and accounting and auditing standards up to date, as these expand and evolve, as well as to adapt to new types of transactions within companies and to new tools made available for conducting audit activities.

#### D. Setting Accounting and Auditing Standards

29. **Accounting and auditing standards are issued by a Division of the Ministry of Finance mostly through translation of international standards (IAS/IFRS and ISA).** Article 9 of the Law on Accounting states that “the Ministry of Finance  develop the methodology of accounting, unified charts of accounts, samples of accounting registers, forms of financial reports, methodological instructions for their completion, as well as accounting standards, compulsory for entities [required to keep accounting books]”. In some cases, modifications to the text of the IAS were made, primarily to simplify the requirements of the standard and make it easier to apply by Moldovan enterprises (see paragraph 36). The preparation of the standards is carried out by the Division of Accounting Methodology and Audit, which consists of twelve permanent working staff of the MoF with civil servant status. The Division of Accounting Methodology and Audit issued the existing NAS and NSA respectively between 1996 and 1998 and in 1999-2000 for the most part, with the support of international donors, mainly USAID. Currently, it lacks the necessary resources to update and expand the standards in line with changes made to the equivalent international standards respectively by the International Accounting Standards Board (IASB) and IFAC’s International Auditing and Assurance Standards Board (IAASB).<sup>30</sup> Under Article 13 of the Accounting Law, a so-called Methodological Consultative Council under the MoF is in charge of “reviewing and development of proposals on disputable issues regarding accounting and financial reporting”. Draft standards are prepared on the basis of the text of IAS/IFRS and ISA translated into both Romanian and Russian, with some adaptations (see paragraph 35 and Appendix). Draft standards are not exposed for comment. Instead advice is sought informally from experienced individuals in the accounting and auditing field and relevant industries, as applicable.

30. **Specific accounting standards and requirements for financial institutions, insurance companies, and listed companies are set by the respective regulator, subject to approval by the MoF.** The NBM has issued accounting standards for banks and other financial institutions subject to approval of the MoF, including NAS 30, *Disclosures in Financial Statements of Banks and Other Financial Institutions*. The CNVM set-out accounting rules and regulations for professional participants and companies listed on the stock market, as does the SIIS for insurance and reinsurance companies for both regulatory and general-purpose financial statements. The process that is followed to set these standards and rules involves some degree of informal consultation with interested parties.

#### E. Enforcement of Accounting and Auditing Standards

31. **The Law does not provide for a clear and effective mechanism for enforcing the accounting and financial reporting requirements on enterprises.** Article 90 of the JSC Law states that “supervision over company activity shall be executed by the authorized state bodies in conformity with the procedure provided by the statutes.” This Article does not define which entities are to ensure enterprises’ compliance with statutory accounting, financial reporting and auditing requirements, and what type of controls authorities should exercise in that matter. The Accounting Law is silent on the issue of compliance. As a result, neither the Statistics Department, the MoF, or the CNVM—which is supposed to exercise some oversight of all open JSCs—conduct any enforcement activities with respect to accounting and auditing requirements.

<sup>30</sup> Considering its budget constraints, the Division of Accounting Methodology and Audit treats as a priority the issuance of new NASs to mirror IASs or IFRSs issued after 1998, rather than updating previously issued NASs.

The CNVM indicated during the ROSC review that they considered their mandate for ensuring compliance with statutory requirements to be restricted to the aforementioned professional participants. The MSE does not carry out any enforcement actions either. The law confers broad sanctioning powers to the authorities against companies who do not comply accounting and financial reporting obligations.<sup>31</sup>

32. **In the banking sector, the NBM plays an active role in enforcing accounting and financial reporting requirements.** The NBM's Department of Banking Regulation and Supervision examines the periodic (annual, quarterly and monthly) reports filed by banks to assess their performance and situation and prepare on-site inspections. On-site inspections are conducted according to a Manual of Field Controls. These cover compliance with accounting standards—including proper use of the chart of accounts, conformity with NAS 30, existence of required daily and monthly records and ledgers; these control procedures are carried-out by NBM's Accounting Department—and an assessment by the Banking Supervision Department of the external audit process and follow-up on issues or recommendations raised by them in prior audits to ensure their resolution or implementation. The NBM organizes periodic meetings with audit firms on technical issues and to discuss the problems encountered in the course of their audits. NBM can request any information from financial institutions for the purposes of its supervision. Under Article 38 of the LFI, NBM can apply administrative sanctions against financial institutions for non-compliance with their statutory and regulatory obligations. Those sanctions include: admonition, penalties applied against the bank (by up to 0.3% of the capital) or the directors (by up to ten months of a average salary), suspension of activities, revoking administrators, and cancellation of banking license.

33. **The SIIS does not monitor compliance by insurance companies with accounting standards to any significant extent mainly due to its lack of resources.** There is no qualified actuary on the staff of the SIIS, which seriously limits the regulator's capacity to verify whether the provisions relating to insurance contracts are correctly calculated—which is one of the most sensitive aspects of accounting by insurance companies. The staff of the SISS is too small to allow on-site inspections.

34. **Neither the MoF nor any of the professional bodies monitor auditors' compliance with NSA and the ethics code.** Under the current Auditing Law, AFAM have the right to recommend the withdrawal of an auditor's license but does not carry out any monitoring process. If the standards of accounting compliance and auditing is to be raised to an acceptable level in Moldova, then a proper monitoring system needs to be set up. Audit firms are statutorily responsible toward the business entity and the beneficiaries of the information “for damages caused as a result of advice of poor quality” (Article 16-1 of the Law on Auditing), but not for non-compliance with NSA and other professional obligation vis-à-vis the shareholders and other financial statement users.

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<sup>31</sup> For instance, the administrative code of 1985 provides for disciplinary measures against infringement of regulation on book keeping, preparation and presentation of financial statements. Article 56 of the Accounting Law prescribes that “persons guilty of violation of this Law, failing to keep accounting records, applying incorrect accounting standards and other normative documents, as well as those who deliberately present false data in financial reports, shall be liable to disciplinary, material, property, administrative or criminal responsibility”. The Tax Code also deals with “violation of accounting rules” (Art. 257).

### III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

35. **Moldova's National Accounting Standards (NAS) were historically developed on the basis of IAS, but they have not been expanded or updated for a number of years.** NAS were issued from 1994 to 1998 on the basis of the IAS standards at the time. In the meantime, the International Accounting Standards Committee (IASC) and its successor the International Accounting Standards Board (IASB) have issued several new standards, and updated or repealed a number of the pre-existing ones. None of the changes made to previously adopted IAS are reflected, and later international standards have no equivalent in Moldova. As a consequence, out of the 36 international standards issued to date and still in force (34 IASs and 2 IFRSs), 15 are not applied in Moldova, and for a number of others the national equivalent (NAS) is out-of-date vis-à-vis IAS.<sup>32</sup> In addition, although integral components of IAS/IFRS, none of the 31 interpretations issued by the IASC's Standing Interpretations Committee (SIC), was incorporated into the NAS. The MoF has issued "Comments on the application of NAS" for a number of the standards, to provide guidance on how standards should be used in specific circumstances considering theoretical examples.

36. **In the absence of a national standard on important matters that can involve material amounts, and because the level of disclosure under NAS is less demanding than under IFRS, the financial information prepared under the NAS is prone to be incomplete, if not inaccurate in certain cases.** Some of the issues where adoption of national standards appear to be particularly needed are (a) employee benefits (IAS 19), (b) financial instruments (IAS 32 and 39), and (c) impairment of assets (IAS 36).<sup>33</sup> Furthermore, issued NAS standards are often less demanding than their counterpart IAS, especially in terms of disclosure but also of recognition and measurement. For instance, NAS 11, *Construction Contracts*, does not require that expected losses at completion of a contract be recognized as soon as they are identified. This is a major shortcoming of the Moldovan standard that is all the more worrisome since construction is an important activity in the country.

37. **The MoF has developed a specific accounting standard for small and medium enterprises (SMEs), which is useful for bookkeeping but needs some simplification and does not provide SMEs with a clear framework for reporting.** NAS 4, *Accounting by Small Business Entities*, was developed pursuant to Article 14 of the Accounting Law (see paragraph 8) to provide a set of "principles of accounting, preparation of accounting registers and financial statements" adapted to SMEs' less complex transactions and resources. It includes an indicative chart of accounts that limits the types of entries to a few basic categories of assets, liabilities, equity components revenues and expenses (e.g., a single account for all revenues), as well as certain off-balance sheet items. The standard then provides detailed guidelines as to how books of accounts should be kept and various examples of accounting statements and worksheets (balance sheet, and income statement, and ledgers). Financial statements produced in accordance with NAS 4 are defined as follows: "balance sheet, income statement, annex to the financial statements and explanatory notes" (NAS 4, paragraph 42). However, no definition is given of the content of those notes (or which of the disclosures required by NAS 5, *Presentation of Financial Statements*, can be omitted or adapted). Moreover, NAS 4 does not set out any principles for the recognition of transactions and for measuring assets and liabilities; SMEs are supposed to refer to the more complex rules set in the NAS standards developed for large enterprises.

<sup>32</sup> A summary of the main differences between IFRS/IAS and NAS is provided in Appendix 1.

<sup>33</sup> The MoF has indicated that the Division of Accounting Methodology and Audit is currently working on a NAS 19, *Employee Benefits*, which is under review by the Methodological Consultative Council, as well as on a NAS 22, *Business Combinations* and NAS 32, *Financial Instruments*.

38. **NAS 30 and NAS 63 provide sound bases for financial reporting by banks and non-banking credit institutions, although they need to be complemented by standards dealing specific issues such as loan loss provisioning.** As previously noted, NAS 30, *Disclosures in Financial Statements of Banks and Other Financial Institutions* is based on its equivalent IAS 30.<sup>34</sup> Although no English translation of the standard could be obtained, a cursory review and discussions with in-country stakeholders indicate that it has the same scope, structure and content as its IAS equivalent (paragraphs 1 to 58); it also incorporates parts of IAS 7, 32 and 39, and has various annexes including templates of financial statements. With respect to NAS 63, *Presentation of Information in Financial Statements of Savings and Credit Associations [SCA]*<sup>35</sup> and *Other Similar Institutions*, it was issued by the MoF in 2002 as a simplified version of NAS 30 due to the lesser sophistication of these entities.

39. **The NBM has issued a specific Regulation dealing with loan loss provisioning by banks for statutory purposes, following an approach that differs from the one recommended by IFRS.** The regulation issued in 1998 requires that banks measure impairment losses on loans using a matrix with fixed provision rates depending on the condition of loan, as follows: standard: 2%; past-due: 5%; sub-standard: 30%; doubtful: 75%; compromised: 100%). This approach, which is often followed by banking supervisors for regulatory financial reporting and is generally considered suitable for prudential purposes, is not consistent with IAS 39, which specifies that impairment losses should be estimated on the basis of the present value of expected future cash flows.<sup>36</sup> General-purpose financial statements of banks (i.e. statutory statements issued to the shareholders and other users than the regulator) should be free of influence of prudential approaches. The best solution should therefore be to adopt IAS 39 (or at least the provisions of the standard that deal with impairment of loans), and possibly to require banks to report separately to the NBM on the structure and quality of their loan portfolios so that the regulator monitor the adequacy of the levels of loan-loss provisions from a regulatory perspective.

40. **Most banks and a number of companies in Moldova prepare a separate set of financial statements under IFRS, in addition to NAS-based statutory financial statements, to satisfy the needs of shareholders or lenders.** This is the case for enterprises who have foreign shareholders or have borrowed from international creditors, including multilateral or bilateral donors. While this contributes to the quality of the financial information, it has the drawback of obliging those companies to keep two different sets of financial statements – one for statutory purposes, the other for investors and lenders – and different accounting records. It creates a disincentive for regulators and stakeholders to strengthen the statutory financial reporting regime and represents an additional administrative burden for these companies.<sup>37</sup>

<sup>34</sup> IAS 30 has almost the same title but refers to “Similar” financial institutions instead of “Other”.

<sup>35</sup> SCAs are a legacy of the Soviet system. Their role is mostly to channel government and donor funding throughout the country, mainly to farmers, in the form of loans of up to US\$ 250,000 with maturities of up to 15 years.

<sup>36</sup> The fact that the two approaches differ is confirmed by the difference in the evaluation of provisions on loans for statutory purposes and under IAS 39 which the ROSC noted by comparing the two sets of financial statements of four large banks. In one case in particular, the amount of provision estimated under IAS 39 as of December 31, 2003 was 20% lower than the amount recorded for statutory purposes.

<sup>37</sup> Comparing the NAS- and IFRS-based financial statements as of December 31, 2003 of one bank, differences were noted on the following aspects: (i) the depreciation periods of property (20 years under NAS and 40 years under IFRS), although in both cases it is supposed to reflect the assets’ useful lives; (ii) loan loss provisioning (see paragraph 39); (iii) impairment of fixed asset (since IAS 36 has not been adopted – see paragraph 36); and (iv) amortization of discounts on loans to customers. On aggregate, the effect these differences was material only on the net income (by approximately 10%). Moreover, a



41. **The review of IFRS-based audited financial statements of four banks did not reveal apparent material departures from the standards.** Due to the present nature of banking activities in Moldova, banks carry-out relatively less complex lending and investment transactions, resulting in relatively simple financial statements. Furthermore, as the banks generally do not have subsidiaries, very few need to prepare consolidated financial statements. For one bank, the IFRS-based financial statements as of December 31, 2003 which were submitted to the ROSC team for review included a recently created leasing company carried as an investment (i.e., not consolidated). IAS 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries* requires that all entities upon which control is exercised (which is the case of that subsidiary) be consolidated. The ROSC team was informed that consolidated financial statements were not available at the time of the review but were prepared later. This is in contradiction with IAS 27 which requires parent company, unconsolidated financial statements to be issued contemporaneously with the consolidated ones. Also, for statutory purposes, interviewed practitioners indicated that the NBM does not enforce NAS 27 (equivalent to IAS 27). The practice of not consolidating certain subsidiaries can impede the financial statements from providing a complete presentation of the bank's financial position and performance, and distort certain key financial ratios (e.g., debt-to-equity ratio, or return on assets).

42. **The statutory audited financial statements of enterprises and non-banking institutions that were reviewed as part of this ROSC did not comply with NAS, and did not even meet the basic requirements to be considered financial statements.** The entities reviewed included five listed companies, one state-owned enterprise (SOE) and four non-banking institutions (insurance company and savings institution). In all cases, prescribed formats for the balance sheet, the profit and loss statement, and the cash flow statement were closely followed, but in none of the cases reviewed were any accounting policies or other explanatory notes presented, in contradiction with NAS 5, *Presentation of Financial Statements*. In the absence of complete information and sufficient details necessary to the analysis and understanding of the company's financial position, performance and cash-flows, as well as contingencies and commitments of the company, the financial statements do not provide a useful tool for shareholders, investors and lenders to make adequately informed corporate, investment, or credit decisions.

#### IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

43. **Moldovan auditing standards (NSA) are for the most part a direct translation of ISA, although they do not include certain recent amendments and additions to ISA.** NSA were issued from 1999 to 2000. Two recently issued ISA have not been translated into a NSA (ISA 315, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement* and ISA 330, *The Auditor's Procedures in Response to Assessed Risks*). Moreover, standards issued by IFAC relating to other types of services have not been adopted.<sup>38</sup> On the other hand, some of the IFAC-issued International Auditing Practice Statements (IAPS) have been translated,<sup>39</sup> which can be helpful to auditors in addressing practical issues relating to specific

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number of the disclosures present in the IFRS-based financial statements were not provided in the NAS-based ones.

<sup>38</sup> They include the International Standards on Review Engagements, the International Standards on Assurance Engagements, the International Standards on Related Services.

<sup>39</sup> e.g., IAPS 1000 Inter-Bank Confirmation Procedures, IAPS 1005 *The Special Considerations in the Audit of Small Entities*, or IAPS 1007 on *Communication with Management*).

circumstances. The MoF has indicated that it intends to issue new national standards (NSA) equivalent to the above ISAs in the near future, as well as practice statements.

44. **Based on interviews conducted by the ROSC team with representatives of various audit firms in Chisinau, auditing practices tend to depart from the standard in several areas.** The main areas where discrepancies between the standard and the practice exist include: (a) third-party confirmation of debtors and creditors, which is an essential procedure to independently verify the accuracy and completeness of these third-party accounts, but are very difficult to implement; (b) stock counts to ensure the existence of inventories—also a basic check that is often not properly carried-out; (c) inquiries of subsequent events and the appropriateness of management's use of the going concern assumption; and (d) quality control for audit work, which appears to be applied only by the audit firms with international affiliation.

45. **The cases of non-compliance with NAS identified by the ROSC in the reviewed financial statements were not mentioned by the auditors in their reports.** Under NSA 700, *The Auditor's Report on Financial Statements*, the absence of explanatory notes on the NAS-based, statutory financial statements (discussed in paragraph 41) should have given rise to adverse opinions in the corresponding audit reports, on the basis that those financial statements were incomplete and possibly misleading.

46. **The environment in which the auditing process is developed in Moldova is not conducive to compliance with auditing standards.** Several factors seem to explain the difficulties or disincentives in complying with established auditing standards, including:

- *Lack of understanding of the audit process by corporate entities* –Representatives of audit firms interviewed as part of this ROSC stated as a difficulty the fact that often companies are not used or equipped to accommodate an external audit. For instance, stock counts are often not properly prepared.
- *Lack of practical experience and technical expertise for applying auditing standards and enforcing accounting standards* – Due to the fact that accounting curricula are not oriented toward practical application of the auditing standards, and that continuing education and training is not mandatory, auditors may experience difficulties in applying NSA effectively.
- *Limited role of governance structures among companies* – As previously noted, audit committees are infrequent in Moldova, as corporate entities are not required to establish them. Yet they are believed to play an important role in ensuring that external auditors fulfill their responsibilities to deliver an audit that meets the needs of the stakeholders.
- *Absence of monitoring and effective sanctions* – As previously noted, there is no monitoring of the compliance with auditing standards and to ensure that practicing auditors in Moldova observe quality assurance procedures (including ISA 220 on quality control of audit work). Also, the law does not explicitly set sanctions against errant auditors, and the fact that financial statements of most companies are not published reduces the possibility that infringement by auditors of their responsibilities are uncovered, thereby weakening auditors' incentive for quality.

## V. PERCEPTIONS ON THE QUALITY OF FINANCIAL REPORTING

47. **Demand for transparent financial statements is still relatively low, due to the lack of availability of financial information, the early stage of development of the securities market and a modest level of foreign investment.** Private investors appear to place limited reliance on statutory financial statements when conducting due diligence as part of their investment projects in Moldova. Instead, they request special-purpose financial statements under IFRS. Observers acknowledge the achievements in the 1990s in developing a reporting framework based on international standards, and the improvement it brought, especially in the banking sector which is generally viewed as producing better quality financial information than the corporate sector. Enterprises' reluctance to disclose information and focus of tax consequences of accounting are widely seen as obstacles to increasing transparency and building-up the quality of the financial reporting. Many interested persons interviewed pointed to the state-owned sector as an area where information was generally not transparent and rarely available.

## VI. FINDINGS AND POLICY RECOMMENDATIONS

### A. Main Findings

48. Private sector accounting and auditing standards in Moldova are significantly incomplete, and compliance with the standards is low. As a result, the accuracy and usefulness of corporate financial statements is limited. The principal observations of the ROSC review of accounting and auditing practices in Moldova follow:

- (i) Over the last ten years, the Ministry of Finance (MoF) has been active in setting accounting and auditing standards for the private sector, with the assistance of international donors. The National Bank of Moldova (NBM) has also been active in developing a financial reporting framework for banks.
- (ii) There is a specific act of law in Moldova dealing with accounting. It focuses on bookkeeping aspects, is very prescriptive, and does not set the underlying principles of financial reporting.
- (iii) National Accounting Standards (NAS) are still in transition toward International Financial Reporting Standards (IFRS). They have not been updated since 1998 and do not incorporate 15 of the current IFRS/IAS standards, and therefore information under NAS is prone to be incomplete, if not inaccurate. Moreover, some of the NAS have significant differences with their IAS equivalent, especially that dealing with construction contracts.
- (iv) A specific standard (NAS 4) has been adopted for small-sized entities. However it focuses on bookkeeping aspects and does not provide a clear framework for reporting.
- (v) National Standards on Auditing (NSA) were issued only a few years ago and are very much in line with International Standards on Auditing (ISA) The MoF has issued several practice statements based on the one issued by IFAC; these are useful for the profession to apply the standards.
- (vi) Most banks and a number of large companies in Moldova prepare IFRS-based financial statements in addition to statutory financial statements, which represents redundant efforts and costs for these companies.
- (vii) Enterprises are not required to make their financial statements available to the public. As

a consequence, the level of financial transparency in the corporate sector is low and it makes it more difficult for investors and banks to carry-out adequate analyses for investment and lending purposes. This hinders enterprises' access to medium/long-term financing.

- (viii) Only banks and the majority of listed companies are statutorily required to have their financial statements audited, which represents a very small number of entities. There is a mandatory Censors' Committees in charge of exercising control over the financial reporting, but this mechanism cannot be construed to be an audit. In the absence of safeguards to ensure the accuracy and fair presentation of the financial statements, shareholders and other interested parties are not adequately protected against erroneous financial information. In addition, this narrow scope of statutory audit requirement this impedes the development of the audit practice in Moldova.
- (ix) The statutory financial statements of enterprises reviewed as part of the ROSC assessment omitted most of the explanatory notes and disclosures required under NAS. This severely limits the financial statements' usefulness for users. It also demonstrates that Censors' Committees are ineffective in ensuring enterprises meet their financial reporting obligations.
- (x) Enforcement of accounting and financial reporting is minimal except in the banking sector, which is one of the explanations to the low level of compliance noted above.
- (xi) The accounting profession is still relatively young and there are still few practitioners with qualification of international standing. There are two professional organizations which do not cooperate with each other. Efforts are made to encourage the membership to obtain international certification.
- (xii) Financial statements of state-owned enterprises (SOEs) appear to be non-compliant with NAS. Consequently, the government and the public are not adequately informed on the financial position and performance of SOEs. Since the mandate Court of Accounts does not currently cover SOEs, these enterprises are not subject to any independent monitoring.
- (xiii) There is a Law on Auditing in Moldova since 1996, which is in the process of being thoroughly reformed to align the Moldovan legislation with international best practices including the EU Eighth directive.

## **B. Policy Recommendations**

49. The principal objective of this ROSC assessment is to assist the Government of Moldova in strengthening the private sector's accounting, financial reporting and auditing practices, as a means to address certain relevant strategic objectives for Moldova, including (a) enhancing the business climate, and bolstering investment in the private sector; (b) stimulating growth in the SME sector by reducing its cost of financing; (c) supporting the stability of the banking sector and mitigating the risk of crises due to loan collection problems; (d) achieving greater financial transparency in the corporate sector, both state and private-owned; and (e) furthering Moldova's economic integration with its main partners, especially EU members.

50. **The Accounting Law should be thoroughly revised to (a) place greater emphasis on financial reporting, (b) provide legal backing for the use of IFRS for statutory purposes and (c) simplify bookkeeping requirements on enterprises.** The new *Accounting and Financial Reporting Law* modeled on the EU Directives should underscore the overall principles and purposes of financial reporting, consistent with the IASB framework for the presentation and preparation of financial statements. Detailed forms and requirements should be dealt with at the level of secondary regulation. The new law should also explicitly mandate the use of either IFRS or NAS for statutory reporting purposes under relevant legislation (JSC Law, LFI, State Enterprises Law, etc.). Allowing entities that already prepare IFRS-based financial statements to report to their shareholders or lenders to file those statements for statutory purposes would reduce the cost of their financial reporting process for them. It would also create the opportunity for other potential users to benefit from that information.

51. **The accounting standard-setter within the MoF should as a matter of priority adopt available Romanian and Russian translations of the all IFRS standards that have not yet been reflected into NAS.** Up-to-date IFRS translations are available both in Romanian and in Russian, from counterpart standard-setting bodies or private organizations. Consistent with the approach followed by other countries who have decided to converge their accounting principles with IFRS, the MoF's Division of Accounting Methodology and Audit should seek to obtain the translated versions of those IASs and IFRSs not already adopted as NAS (see Appendix). The translated standards would then be circulated among a wide range of stakeholders, including preparers, audit firms, professional bodies, bankers, investors, etc., requesting comments from them. If necessary and in a limited number of occurrences, the standards could be adapted by removing certain optional treatments or adding certain requirements or guidelines. Additionally, NAS 11, *Construction contracts*, and NAS 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*, should be further aligned with their IAS equivalents.<sup>40</sup>

52. **NAS 4, *Accounting for Small Business Entities*, should be revised to provide a comprehensive reporting framework for SMEs.** NAS 4 should be expanded to provide, in addition to record-keeping rules and templates of basic financial statements, the following information: (a) the objectives and attributes of the financial statements, (b) the requirements in terms of recognition, measurement, presentation and disclosures for each main category of assets, liabilities, revenues and expenses, and (c) a model of simplified notes to the financial statements. The MoF should monitor IASB's recently initiated project to develop a set of accounting principles adapted to SMEs.<sup>41</sup>

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<sup>40</sup> The MoF indicated to the ROSC team that “ the Division of Accounting Methodology and Audit (...) does not have the most recent information about international accounting regulations, including the most recent translation of IFRS in Romanian or Russian”.

<sup>41</sup> The *Financial Reporting Standards for Small Entities*, originally issued in 1997 by the Financial Reporting Council of the United Kingdom and updated regularly since, could also serve as a reference.

53. **The proposed new *Accounting and Financial Reporting Law* and amendments to the Joint-Stock Company (JSC) Law should require public-interest entities<sup>42</sup> to file their annual financial statements with a public registry of companies. This registry could be established under the National Securities Commission (CNVM).** Under the JSC and Accounting laws, all joint stock companies are already required to prepare a full set of financial statements in conformity with NAS, so this requirement in theory does not require more efforts on the part of companies. The registry of companies would compile annual financial statements and review their compliance with the law in terms of completeness and form (see also paragraph 53). Any interested party (authorities, creditors, suppliers, banks, and any third party) could request a copy of the financial statements which would be made available for a limited fee. Considering that legal opinion in Moldova indicate that CNVM is legally entrusted with supervising all JSCs, the Registry of companies should thus be established under CNVM. The Registry should have the authority deny registration in case of incomplete statements, and to levy fines for late submission. Moreover, the authorities should consider the possibility of extending to all open joint stock companies the requirement to file financial statements with the public registry, as this would bolster financial transparency in the corporate sector and broaden investors' and lenders' access to financial information.

54. **The JSC Law, State Enterprise Law and Law on Enterprises should also be amended to require statutory financial statement audits in all public interest entities as previously defined.** This would be consistent with the EU Fourth Directive on Company Law and would be an important step toward enhancing enterprises' compliance with NAS and improving the quality of the financial information they present.

55. **Amend the JSC Law and related regulations to clarify the role of the Censor's Commission with respect to the financial reporting process and restrict the obligation to have Censors to entities not subject to statutory audits.** For public-interest entities, the role of Censors would be redundant for the most part with that of external auditors. Regarding JSCs that would not be subject to the requirement discussed in paragraph 52 (which would represent the overwhelming majority of JSCs), regulation should provide guidelines on how they should carry-out their mission especially with regards to examining the annual financial statements and a standard reporting should be developed by the CNVM setting forth the scope and extent of their work and their conclusions.

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<sup>42</sup> Public-interest entities are defined as listed companies, banks, insurance companies, pension funds, and those entities bearing significant importance to a country on account of the nature of their business, ownership (e.g., state-owned enterprises) or size as measured by the number of employees, revenues generated annually and assets owned (the corresponding thresholds provided by the Fourth European Directive on Company Law are respectively 250 employees, €12.5 million, and €25 million; it could be used as a reference, probably with lower amounts). Based on data provided by the Department of Statistics on the country's top 100 enterprises as measured by the amount of revenues and number of employees in 2002, there were 55 enterprises with more than 250 employees in Moldova during that year. In addition, these 100 enterprises had revenues of MLD 80 million (equivalent to € 8 million) or more. Based on the above, setting the proposed public filing requirement with a scope consistent to the one prevailing in the EU would affect approximately 100 enterprises in Moldova.

56. **The new Auditing Law that is being drafted by the MoF should be finalized promptly in a way that would ensure that statutory audits provide effective protection to shareholders and other users of the financial statements.** Since late 2003, the MoF has undertaken to review the existing Auditing Law to identify changes needed to improve the legislative and regulatory framework underpinning the audit practice in a manner consistent with the recommendations of the CFAA published in September 2003.<sup>43</sup> According to the MoF, a draft Law was submitted for review at the working session of the Government of Moldova on May 27, 2004. The main suggested areas of improvements in the new Law are summarized in Box 1. The MoF has indicated that new Law should adequately address the issues raised in this report.

#### **Box 1 – The new Auditing Law**

The new Law on Auditing is expected to provide a comprehensive regulatory framework that would pave the way for a significant improvement in the audit practice, and in turn to a increase in the quality of enterprises' statutory financial statements. The main suggested areas of improvement in the Law are summarized below:

- Definitions and terminology provided in the Law should be harmonized with international best practices, including IFAC standards and EU legislation. For instance, the definition of an audit should include the concepts of “true and fair view”, materiality, reasonable assurance, basis of reporting, responsibilities of the management, etc.
- The law should include a specific chapter on professional standards (i.e., auditing, assurance, ethics and quality control) which the auditors are to apply to discharge their duties. It should state that those professional standards are to be developed by the public body in charge of the oversight of the audit practice, within the framework of the standards issued by IFAC and with reference to best practices such as EU directives. It should also require that auditors be qualified as a result of a due process in line with IFAC's educational standards that would ensure that would-be statutory auditors have demonstrated adequate practical skills and ability to exercise a professional judgment.
- The Law should entrust the supervision of audit activities to an Audit Oversight Council (AOC), an autonomous public body under the Ministry of Finance, the NBM and the CNVM. The functions of the AOC would include (i) setting professional standards as discussed above, (ii) certification of auditors for purposes of licensing, (iii) instituting continuing education, and (iv) assuring quality control and monitoring of compliance with ethical requirements. The AOC would act as the regulator of the audit practice and the enforcer of the Law on Auditing on behalf of all authorities concerned (MoF, NBM, CNVM, SIIS, MSE, etc.). The AOC would be governed collegially by representatives of these authorities; its membership would also include representatives of the financial community, the profession and the academic community. The activities and findings of the AOC would be disclosed to the public so as to increase the confidence of financial statement users in the reliability of the financial reporting process in Moldova and in auditors' effectiveness in ensuring compliance by companies with their statutory obligations to report.
- The new Law should provide for the possibility for the Audit Oversight Council to delegate some of its functions to a professional body with adequate institutional capacity to conduct them on a day-to-day basis. Such delegation could be done through a formal agreement under the By-laws of the Audit Oversight Council and could cover continuing education and training and even professional examination. In that respect, the Law should expressly accommodate the possibility that the AOC could endorse international certifications of acceptable quality could be endorsed in lieu of the existing certification.
- The responsibilities of management regarding the preparation of the financial statements and for ensuring that all relevant documentation and information is made available to auditors.

<sup>43</sup> A first draft has been submitted for comments to World Bank staff who provided them. As part of the follow-up of to this review of accounting and auditing practices, the ROSC task team will maintain the dialogue with the Ministry to provide guidance on the finalization of the draft law.

57. **CNVM's powers and capacity for enforcing accounting standards and financial reporting requirements should be strengthened.** Under the law, CNVM has “powers of decision, exemption, interdiction, intervention, control and administrative and disciplinary sanctions on the securities market”. These provisions extend to all JSCs as their shares must be issued on the off-the-exchange (see paragraph 3) market over which CNVM has authority. However, discussions with CNVM during the ROSC review have indicated that its own interpretation is that its role should be focused on the professional participants. Accordingly, the JSC Law should be amended to clarify that the role and responsibilities of CNVM extends to all JSCs. In order for CNVM to carry-out its supervisory and enforcement functions over JSCs, (including public filing, reporting in accordance with NAS or IFRS and auditing as proposed in paragraphs 53 and 54 above), a division should be set-up within CNVM in charge of (i) reviewing the financial statements filed with the Registry, (ii) request any additional information from companies and auditors, (iii) conduct period off-site inspections at companies, and (iv) impose administrative sanctions for non-compliance.<sup>44</sup> To ensure the transparency of the process, deter enterprises from not complying, and foster users' confidence in the effectiveness of the regulatory regime, CNVM would report each calendar year on enforcements actions conducted, issues addressed and possibly sanctions taken.

58. **Similarly, in the insurance sector, the State Inspectorate (SIIS) should enhance its capacity for monitoring compliance with accounting and reporting requirements.** Specifically, the staff of the SIIS should include actuaries who would review the calculations by insurance companies of the provisions relating to insurance contracts.

59. **Academic curricula in the field of accounting and auditing, as well as professional education and training, should be strengthened.** In order for future practitioners, especially would-be auditors, to have a sufficiently strong academic background in accounting and auditing, university curricula leading to the degree of graduate in accounting should be updated to accommodate issues of financial reporting, accounting principles and auditing standards, and practical application of the standards. In that regard, consideration should be given to requiring students have to do an apprenticeship as part of the curriculum. Furthermore, professional accountants should be required to follow training programs to improve and update their knowledge of international standards and best practices in the field of accounting and auditing.

60. **Some of the recommendations of this ROSC will likely require substantial technical assistance and training.** As previously indicated, the Country Action Plan will identify key activities including designing processes and organizational structures, drafting new legislation or regulation, and dealing with issues of human resources that would support the implementation of the ROSC recommendations and the related technical assistance. Areas that may require technical assistance include: (a) setting-up the public registry of company annual accounts under the CNVM, and the links with other interested bodies (department of statistics, tax authorities, NBM, etc.); (b) establishing detailed processes for the enforcement of financial reporting requirements by CNVM under company law; (c) designing the By-laws of the Audit Oversight Council, and the detailed processes under which it would operate; (d) developing a process for endorsement and monitoring of auditor certification; (e) reviewing and drafting amendments to existing Law on Accounting; (f) updating and improving NAS 4 for use by SMEs, and (g) adoption of IFRS for use by all public interest companies and further development harmonization of NAS in line with IFRS.

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<sup>44</sup> CNVM would not directly supervise banks as these are under the purview of the NBM for all matters of compliance including financial reporting.



## APPENDIX

### Summary of Differences between IFRS and Moldova's National Accounting Standards (NAS)

	International Standard	NAS	Comment
IAS 1	Presentation of Financial Statements	5	No significant differences with equivalent IAS
IAS 2	Inventories	2	No significant differences with equivalent IAS
IAS 7	Cash Flow Statements	7	No significant differences with equivalent IAS
IAS 8	Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies	8	This standard is not available in the English language. Most issues appear to have been dealt with in NAS 8.
IAS 10	Events After the Balance Sheet Date	10	This standard is not available in the English language. Most issues appear to have been dealt with in NAS 10.
IAS 11	Construction Contracts	11	NAS is substantially in line with IAS, except for the absence of provisions for losses at completion on unprofitable contracts
IAS 12	Income Taxes	12	No significant differences with equivalent IAS
IAS 14	Segment Reporting	14	No significant differences with equivalent IAS
IAS 15	Information Reflecting the Effects of Changing Prices	15	<i>No equivalent NAS</i>
IAS 16	Property, Plant and Equipment	16	No significant differences with equivalent IAS
IAS 17	Leases	17	No significant differences with equivalent IAS
IAS 18	Revenue	18	No significant differences with equivalent IAS
IAS 19	Employee Benefits	n/a	<i>No equivalent NAS</i>
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance	20	This standard is not available in the English language. Most issues appear to have been dealt with in NAS 20.
IAS 21	The Effects of Changes in Foreign Exchange Rates	21	No significant differences with equivalent IAS
IAS 22	Business Combinations		<i>No equivalent NAS</i>
IAS 23	Borrowing Costs	23	No significant differences with equivalent IAS, although the NAS standard follows a different presentation and differs in some aspect with IAS 23
IAS 24	Related Party Disclosures	24	No significant differences with equivalent IAS
IAS 26	Accounting and Reporting by Retirement Benefit Plans	n/a	<i>No equivalent NAS</i>
IAS 27	Consolidated Financial Statements and Accounting for Investments in Subsidiaries	27	The NAS is a simplified version of IAS 27. It includes a reference to NAS 22, <i>Business Combinations</i> , which has not been issued yet
IAS 28	Accounting for Investments in Associates	28	Another simplified version of the IAS which is more than advanced for the present market place. Consolidated financial statements are not extensively understood or used so the importance of the process seems somewhat in doubt. Associates are even more esoteric
IAS 29	Financial Reporting in Hyperinflationary Economies	n/a	<i>No equivalent NAS</i>
IAS 30	Disclosures in the Financial Statements of Banks and Similar Financial Institutions	30	Most issues have been dealt with in NAS 30 –Disclosures in the Financial Statements of Financial Institutions. However, this standard is not available in the English language
IAS 31	Financial Reporting of Interests in Joint Ventures (Up Dated 2000)	31	Joint ventures are important in the present climate here and this standard is close enough to be effective
IAS 32	Financial Instruments: Disclosure and Presentation	n/a	<i>No equivalent NAS</i>
IAS 33	Earnings per Share	n/a	<i>No equivalent NAS</i>
IAS 34	Interim Financial Reporting	n/a	<i>No equivalent NAS</i>
IAS 35	Discontinuing Operations	n/a	<i>No equivalent NAS</i>
IAS 36	Impairment of Assets (Up Dated 1998)	n/a	<i>No equivalent NAS</i>
IAS 37	Provisions, Contingent Liabilities and Contingent Assets	n/a	<i>No equivalent NAS</i>
IAS 38	Intangible Assets	n/a	<i>No equivalent NAS</i> . Some aspects are dealt with in NAS 13, but there are major differences.
IAS 39	Financial Instruments: Recognition and Measurement (Up Dated 2000)	n/a	<i>No equivalent NAS</i>
IAS 40	Investment Property	n/a	<i>No equivalent NAS</i>
IAS 41	Agriculture	6	NAS 6 is a well set out but complex standard which goes much further than the IAS.
IFRS 1	First-time Adoption of International Financial Reporting Standards	n/a	<i>No equivalent NAS</i>
IFRS 2	Share-based Payment	n/a	<i>No equivalent NAS</i>
IFRS 4	Insurance Contracts	n/a	<i>No equivalent NAS</i>

Note: IAS 3, 4, 5, 6, 9, 13, 25 have been repealed - NAS 9, *Accounting for Expenses on Research and Development* is still in force.

