

# REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC) Republic of Poland

## ACCOUNTING AND AUDITING

February 8, 2005

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### Executive Summary

This report acknowledges the very significant progress achieved by Poland under the leadership of the Ministry of Finance since publication of the first accounting and auditing ROSC report in July 2002. This report provides an assessment of accounting, financial reporting, and auditing requirements and practices within the enterprise and financial sectors in Poland.

The report uses International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA) as benchmarks and draws on international experience and good practices in the field of accounting and audit regulation. The assessment also has regard to the relevant requirements of EU law (also known as the *acquis communautaire*). The report sometimes takes a position that goes well beyond what is presently practice in most EU Member States (e.g., it recommends the use of IFRS and of ISA for a large number of companies and for all statutory audits, and relies on the international initiatives currently underway at the international level to ensure that these standards, and the related standard setting processes, will be further enhanced). These positions are clearly identified in the report.

Companies (including limited liability companies and joint stock companies) are required to prepare their financial statements in conformity with Polish accounting requirements, which are based on the Fourth and Seventh EU Company Law Directives and provide a simplified financial reporting framework for small and medium sized enterprises. Banks (both listed and nonlisted) are required to prepare their consolidated financial statements in conformity with *endorsed* IFRS, and their legal entity financial statements in conformity either with accounting regulations set by the Minister of Finance, which are based on the Banking Accounts Directive, or with endorsed IFRS. Insurance companies are required to prepare their financial statements in conformity with accounting regulations set by the Minister of Finance, which are based on the Insurance Accounts Directive. Companies listed on the Warsaw Stock Exchange are required to prepare their consolidated financial statements in conformity with *endorsed* IFRS. Furthermore, a company may opt to use IFRS in its consolidated financial statements if (a) it has applied for admission to public trading, or (b) it is a subsidiary of a parent which prepares its consolidated accounts in accordance with IFRS. In addition, a company may opt to use IFRS in its legal entity financial statements if (a) it is a listed company, (b) it has filed

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This report was prepared by a team from the World Bank on the basis of the findings from a diagnostic review carried out in Poland between November 2004 and January 2005. The staff team was led by Frédéric Gielen (ECSPS) and comprised of Iwona Warzecha (ECSPS) and a team of experts from relevant institutions in EU Member States. The review was conducted through a participatory process involving various stakeholders and led by the country authorities.

### Executive Summary (Continued)

for admission to public trading, or (c) it is a subsidiary of a parent which prepares its consolidated accounts in accordance with IFRS.

In order to better meet the expectations and needs of users of financial statements prepared by public interest entities (e.g., banks, insurance companies, all listed companies), this report recommends that public interest entities be required to prepare their consolidated financial statements in conformity with IFRS. Clearly, this measure would go a step ahead of the current requirements of the *acquis*, as this is not yet required by the EU—other than for the consolidated financial statements of listed companies—however, the ROSC team believes that it would be valuable for enhancing the transparency of financial reporting of public interest entities.

Polish enterprises are subject to statutory audit requirements, which are consistent with the existing *acquis* requirements. These audit requirements are generally conducive to greater compliance with accounting standards although the report notes variation in the quality of statutory audits. Consequently, this report strongly recommends that existing arrangements be reassessed in the wake of the proposal for a new Eighth EU Company Law Directive, which will require enhanced public oversight of the auditing profession.

This report shows that priorities should now turn to building the monitoring, supervisory and disciplinary regimes necessary to ensure effective compliance. This assessment demonstrates that the effective enforcement of accounting, auditing and ethical standards is the next challenge that Poland has to tackle.

While the report highlights a major program of required reforms to ensure practices catch up with recent regulatory enhancements, the report commends Poland for its achievements to date, some of which go beyond what is presently required by the *acquis communautaire* and what “peer” large EU Member States are presently doing.

## I. INTRODUCTION

1. This assessment of accounting and auditing practices in Poland is part of a joint initiative of the World Bank and the International Monetary Fund (IMF) to prepare Reports on the Observance of Standards and Codes (ROSCs).<sup>1</sup> The assessment focuses on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting and involves a review of both mandatory requirements and actual practice. It uses International Financial Reporting Standards (IFRS)<sup>2</sup> and International Standards on Auditing (ISA) as benchmarks, and draws on international experience and good practices in the field of accounting and audit regulation. For European Union (EU) Member States the assessment also has regard to the relevant requirements of EU law (also known as the *acquis communautaire*).

2. Poland has a population of 38.2 million and gross domestic product (GDP) per capita of US\$ 11,427 as of end-2004.<sup>3</sup> In the past 15 years the country has undergone a remarkable economic and social transformation. Its impressive record includes uninterrupted annual economic growth averaging 5 percent during the 1990s. Poland acceded to the EU in May 2004.

3. The private sector's contribution to GDP at factor cost (gross value added) rose from around 18% in 1989 to 72.4% in 2002, including a significant contribution from small and medium sized enterprises (SMEs). While the pace of privatization had slowed sharply since 2001, the Government has recently indicated that they wish to improve the corporate governance of state-owned firms and move forward with privatization. At present, there remains a significant number of *public interest entities*,<sup>4</sup> which are state-owned (e.g., railway, coal mining, financial services), which are not listed. Assessing SME and state-owned enterprise financial reporting requirements and practices was deemed important in the context of this report and consistent with the Government's objective to improve the corporate governance of these enterprises.

4. During the first decade after the start of its transition from a centrally planned to a market economy, Poland successfully resolved the overhang of central planning on its financial system: the banking system was restructured and mostly privatized, and is now to a large extent under reputable foreign bank ownership; the Warsaw Stock Exchange (WSE) was reopened and is now one of the more dynamic stock markets in Eastern Europe; an early pension reform effort has created a rapidly growing second pillar private pension system; and the insurance sector was modernized.

5. As at end-2004, the Warsaw Stock Exchange (WSE) and the MTS-CeTO (a regulated off-Exchange market) have 230 listed companies (206 on the main list—continuous trading system, and 24 on the parallel list—single-price auction system) and 18 listed companies, respectively. The Warsaw Stock Exchange had a total capitalization of PLN 292 billion

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<sup>1</sup> This assessment is an update of the Poland Accounting and Auditing ROSC report dated July 25, 2002, which is available at <http://www.worldbank.org/ifa/poland0702.pdf>.

<sup>2</sup> Within this report, IFRS refer to both International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board and the Standards issued by the Board of the International Accounting Standards Committee, and each applicable Interpretation of the International Financial Reporting Interpretations Committee.

<sup>3</sup> Gross domestic product based on purchasing-power-parity per capita, International Monetary Fund, World Economic Outlook Database, September 2004.

<sup>4</sup> Within this report, public interest entities are those in which the general public has an interest by virtue of the nature of their business, their size, their number of employees, or their range of stakeholders. Examples include banks, insurance companies, investment funds, pension funds, listed companies, and large enterprises, including large the state-owned enterprises.

(equivalent to approximately EUR 71.5 billion),<sup>5</sup> which represented approximately 33 percent of the estimated gross domestic product in 2004. At the end of 2004, there were 59 commercial banks and 597 cooperative banks operating in the Polish banking system, 73 insurance companies, 149 licensed investment funds, and 16 mandatory second pillar private pension funds.

6. Domestic credit to the corporate sector and leasing are major sources of investment finance (leasing less so). Because the interest differential between Poland and the euro area remains high, a lot of transactions are conducted in euro. In such an environment, it is essential for financial system stability purposes that accounting requirements and practices adequately measure foreign currency risk exposure.<sup>6</sup> Although the WSE is the largest among the new EU Member States in terms of market capitalization, it remains relatively small in absolute terms, and is not yet a major source of industrial investment finance.

7. This ROSC accounting and auditing report was planned and undertaken based on the aforementioned characteristics. Therefore, it sketches policy recommendations to enhance the quality of corporate financial reporting and seeks to foster a financial reporting platform conducive to increased tax collection, private sector growth, development of the second pillar private pension system,<sup>7</sup> and reduced financial system instability.

## II. INSTITUTIONAL FRAMEWORK

### A. Statutory Framework

8. **In law, Poland implemented the *acquis communautaire*.** The existence of a well-developed *acquis* in the area of accounting and auditing regulation facilitated the choice of appropriate models to follow. However—like other EU Member States—Poland has to address significant issues in the design and strengthening of suitable institutions to implement and enforce the *acquis* requirements. In addition, it is crucial for Polish policymakers and regulators to take an active role in the policymaking process of the European Union. In this context, it is very positive to note that Poland is already active in both the EU Committee on Auditing and the Accounting Regulatory Committee, and participates in the Committee of European Securities Regulators (see paragraph 48 below).

9. **The Code of Commercial Partnership and Companies (the “Commercial Code”), based on European Company Law Directives, regulates business activities in Poland.** The Code was enacted by the Polish Parliament on September 15, 2000. The Commercial Code, which was last amended in December 2003, recognizes two main corporate forms, which are based on German models:<sup>8</sup>

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<sup>5</sup> Value based on the rate applicable on December 31, 2004: Polish Zloty (PLN) 1.00 = EUR 0.245 (source: European Central Bank).

<sup>6</sup> In this context, the issues noted in paragraph 58 may be worrying, since certain companies choose the Euro or the US\$ as a measurement currency and hence are not capturing the foreign exchange exposure on Euro or US\$ denominated loans. As indicated in paragraph 58, the issue is one of accounting practice and not of accounting requirements. The policy recommendations set forth in this report emphasize the importance of accounting standards enforcement, including on such technical matters.

<sup>7</sup> As at end 2004, approximately 12 million members were contributing close to EUR 3 billion per year in the mandatory second pillar private pension system. The funds are allowed to invest up to 25% of their assets in equity securities.

<sup>8</sup> The Code also recognizes a variety of partnership forms.

- *The limited liability company (spółka z ograniczoną odpowiedzialnością, or Sp. z o.o.),* the shares of which are not publicly tradable. Limited liability companies generally have a small number of shareholders and a minimum capital of PLN 50,000 (equivalent to approximately EUR 12,200). Limited liability companies generally have a single-tier management structure (management board) composed of one or more members. However, the articles of association may provide for the establishment of a supervisory board and/or audit commission. A supervisory board is required in companies with a capital greater than PLN 500,000 (equivalent to approximately EUR 122,000) and more than 25 shareholders. At the end of 2003, there were approximately 100,700 limited liability companies registered in Poland.
- *The joint stock company (spółka akcyjna, or S.A.),* the shares of which may be publicly tradable. Stock companies generally have a large number of owners and a minimum capital of PLN 500,000 (equivalent to approximately EUR 122,000).<sup>9</sup> Joint stock companies have a two-tier management structure (management board and supervisory board). At the end of 2003, there were approximately 6,000 joint stock companies.

The Code only contains a very limited number of provisions in respect of accounting requirements.

10. **The Commercial Code and the Accounting Act do not establish that members of the board of directors must be collectively responsible for the probity of legal entity and consolidated financial statements.**<sup>10</sup> Under the Accounting Act, the management board is responsible for the preparation of annual financial statements within three months of the year-end. The Accounting Act also requires that financial statements be signed and dated by the person responsible for keeping the books and all the members of the management board.<sup>11</sup> The board of directors is “jointly and severally” liable for the probity of financial statements.<sup>12</sup>

11. **In addition to the above civil liability provisions, the Accounting Act provides for criminal liability of members of the board of management for non-compliance with the provisions with regards to keeping books of accounts and the preparation of financial statements.**<sup>13</sup> Penalties for non-compliance include fines, two years in prison or both.<sup>14</sup> However, despite a high incidence of qualified audit opinions the ROSC team found little evidence of sanctions, either legal or market driven, against directors of companies where the financial statements included a qualified audit opinion (see paragraph 49 below).<sup>15</sup>

<sup>9</sup> Companies in the financial sector (banks, insurance companies, investment funds and pension funds) are subject to different requirements, as set forth in the specific laws regulating their activities. For example, banks are required have a minimum capital of EUR 5 million; and insurance companies, of EUR 2 or 3 million, depending on the type of insurance (the insurance regulation, however, includes transitional provisions that allow insurance companies to maintain their minimum capital on the level of EUR 200,000 to 800,000 through end-2006).

<sup>10</sup> The Commercial Code is silent on the responsibility of the board of directors for the probity of financial statements.

<sup>11</sup> See Articles 52 and 63c of the Accounting Act.

<sup>12</sup> This report outlines the legal principles applicable with regard to directors’ liability and does not attempt to give anything more than an introduction to the issues. This report is not meant to be an exhaustive rendition of the law nor is it legal advice to those reading it. See Section 165ff. of the Commercial Law for further details.

<sup>13</sup> For a detailed analysis of the responsibility of directors, refer to the Corporate Governance ROSC for Poland, which was conducted contemporaneously with this assessment.

<sup>14</sup> See Article 9 of the Accounting Act.

<sup>15</sup> The fact that only few criminal sanctions have been imposed upon directors for preparing “false or misleading” financial statements may be explained by the fact that criminal sanctions are generally a

12. **In line with what is currently prevailing in most EU Member States, shareholders are required to approve the financial statements of a company.** The Commercial Code requires that the meeting of shareholders approve the financial statements of the company and the distribution of profits within six months of the year-end. This provision is in line with what currently prevails in most EU Member States. Shareholders are also required to approve consolidated financial statements of a company; however this need not occur at the annual general meeting, as the deadline for approving the consolidated financial statements of a company is eight months of the year-end,<sup>16</sup> and the annual general meeting must take place at the latest within six months of the year-end.

13. **Financial reporting by Polish enterprises is governed by various laws and regulations, which include very detailed accounting requirements primarily based on the Fourth and Seventh EU Company Law Directives, the Banking Accounts Directive,<sup>17</sup> and the Insurance Accounts Directive.<sup>18</sup>** The application of corporate financial reporting requirements to different enterprises is summarized in Table 1, which should be read in conjunction with paragraphs 14 to 18:

<b>Financial statements</b> <b>Entities</b>	<b>Legal Entity Financial Statements</b>	<b>Consolidated Financial Statements</b>
<b>Joint Stock and limited liability companies</b>		
<b>Large</b> <i>(Paragraphs 14 and 15)</i>	Detailed accounting requirements within the Accounting Act; Decree of the Minister of Finance on Financial Instruments	Detailed accounting requirements within the Accounting Act; Decree of the Minister of Finance on Consolidation
<b>Small and medium-sized</b> <i>(Paragraphs 14 and 15)</i>	Same requirements with exemptions allowing for simplified financial reporting.	Same requirements with exemptions allowing for simplified financial reporting.
<b>Banks</b> <i>(Paragraph 17)</i>	Detailed accounting requirements within the Accounting Act and Regulations issued by the Ministry of Finance	<i>Endorsed IFRS</i>
<b>Insurance companies</b> <i>(Paragraph 18)</i>	Detailed accounting requirements within the Accounting Act and Regulations issued by the Ministry of Finance	
<b>Listed joint stock companies</b>		
<b>Main list</b> <i>(Paragraph 16)</i>	Detailed accounting requirements within the Accounting Act and the provisions of public trading in securities. <i>Endorsed IFRS</i>	<i>Endorsed IFRS</i>
<b>Parallel list</b> <i>(Paragraph 16)</i>		

difficult means to sanction financial reporting requirements. They require a very difficult test on behalf of the public prosecutor who introduces the case because of the subjectivity that is inherent in the application of many financial reporting requirements.

<sup>16</sup> See Article 63c.4 of the Accounting Act.

<sup>17</sup> See European Council Directive 86/635/EEC dated December 8, 1986 on the annual accounts and consolidated accounts of banks and other financial institutions.

<sup>18</sup> See European Council Directive 91/674/EEC dated December 19, 1991 on the annual accounts and consolidated accounts of insurance undertakings.

Free list (Paragraph 16)	allowed	
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**Table 1: Corporate Financial Reporting Requirements**

14. **The Accounting Act enacts the provisions set out in the Fourth and Seventh EU Company Law Directives, as amended in June 2003.** The Accounting Act, which was last amended in August 2004, is the primary piece of legislation regulating accounting and financial reporting. It applies to all joint stock and limited liability companies, including banks, insurance companies, listed companies, and pension and investment funds. The Law lays down the principles which govern the drawing up of legal entity financial statements, states general principles for the valuation of items in the financial statements (e.g., prudence) and specific valuation rules, and lists the information which must be provided in the notes to the financial statements. It is largely based on the Fourth and Seventh EU Company Law Directives, including the most recent amendments thereto,<sup>19</sup> with the following interesting elections:<sup>20</sup>

- The Act imposes that all companies subject to statutory audit requirements (see paragraph 19 below) prepare financial statements comprising a balance sheet, an income statement, a cash flow statement,<sup>21</sup> a statement of changes in equity, and notes. This requirement is more demanding than the current requirements of the *acquis communautaire*,<sup>22</sup> which do not mandate statements of cash flow and of changes in equity. This requirement is in line with the Directives' implementation in a number of Member States and provides the users of audited (consolidated) financial statements with useful additional information.
- As permitted by the Directives and in line with their implementation in most Member States, simplified reporting rules are laid down for SMEs. SMEs are defined as companies, which on their balance sheet date, do not exceed the limits of two of the three following criteria: balance sheet total of EUR 2 million, net turnover of EUR 4 million, and 50 employees. These thresholds are lower than the maximum amounts set out in the Fourth EU Company Law Directive (EUR 3.65/ 14.6 million, EUR 7.3/29.2 million, and 50/250 employees).<sup>23</sup> Consequently, among Poland's 106,700 limited liability and joint stock companies, only approximately 14,600 are allowed to apply simplified financial reporting requirements.
- As permitted by the Directive and in line with the Directives' implementation in most Member States, the Act exempts small groups of companies from consolidation requirements. Small groups of companies are defined as groups where the parent

<sup>19</sup> The latest amendment (Directive 2003/51/EC of the European Parliament and of the Council dated June 18, 2003) set out to harmonize the accounting rules applied to non-publicly traded companies with IFRS. Consequently, most IFRS accounting treatments and disclosures can now be applied to companies that retain the accounting Directives as their basic legislation.

<sup>20</sup> The Fourth and Seventh EU Company Law Directives include a lot of options, which Member States have to decide upon when transposing the Directive in national law. The report merely highlights the primary striking points in the Polish transposition of the Directives.

<sup>21</sup> Open-ended investment funds are not required to present a cash flow statement (see Article 45.3a of the Accounting Act).

<sup>22</sup> See Articles 2 and 16 of the Fourth and Seventh EU Company Law Directives, respectively.

<sup>23</sup> See Articles 11 (thresholds applying to abridged balance sheets) and 27 (thresholds applying to abridged profit and loss statement) of the Fourth EU Company Law Directive. For comparison purposes, the approximate thresholds in select Member States are: Belgium (EUR 2.5 million, EUR 5 million, 50); Czech Republic (EUR 1.3 million, EUR 2.6 million, and 50 employees); Germany (EUR 10.5 million, EUR 21 million, 250); Lithuania (EUR 1.4 million, EUR 2.8 million, 10); and Slovenia (same thresholds as in the Directive).

company and the companies to be consolidated do not together, on the basis of their latest legal entity financial statements, exceed the limits of two of the three following criteria: balance sheet total of EUR 7.5 million, net turnover of EUR 15 million, and 250 employees. In line with the Directive, this exemption is not available to listed companies.<sup>24</sup>

15. **All Polish companies—with certain exceptions, as set forth in paragraph 16 below—are required to prepare their legal entity and consolidated financial statements in accordance with detailed accounting requirements within the Accounting Act and its regulatory decrees.** Article 10.3 of the Accounting Act states that companies are required to follow the provisions of the Act but where no specific provisions exist within the Act then a company “may” apply National Accounting Standards, and where these are silent then it “may” follow *endorsed* IFRS.

16. **From 2005 the Accounting Act requires that the consolidated financial statements of listed companies and all banks (both listed and non-listed) must comply with *endorsed* IFRS (i.e., IFRS adopted by the European Commission).**<sup>25, 26, 27</sup> As permitted by EU Regulation 1606/2002, the general meeting of shareholders of such companies and their subsidiaries may elect to use *endorsed* IFRS for their entity financial statements in preference to Polish accounting requirements.<sup>28</sup> Issuers of debt securities are obliged to adopt *endorsed* IFRS for their consolidated financial statements from 2007, but can elect to adopt *endorsed* IFRS from 2005.<sup>29</sup> Furthermore, a company may opt to use IFRS in its consolidated financial statements if (a) it has applied for admission to public trading, or (b) it is a subsidiary of a parent which prepares its consolidated accounts in accordance with IFRS. In addition, a company may opt to use IFRS in its legal entity financial statements if (a) it is a listed company,<sup>30</sup> (b) it has filed for admission to public trading, or (c) it is a subsidiary of a parent which prepares its consolidated accounts in accordance with IFRS.

17. **The Banking Act of August 29, 1997 (as amended), requires banks to prepare financial statements in compliance with the Accounting Act and the Regulations issued by the Minister of Finance.**<sup>31</sup> Banks are required to submit their annual legal entity (consolidated) financial statements to the Banking Supervision Commission within 15 (30) days of the approval thereof, i.e. within six and a half (seven) months of the year-end.<sup>32</sup> Although the Regulations issued by the Minister of Finance have been updated based on the most recent changes to the EU Banking Accounts Directive, the ROSC team contemplates potential conflicting financial reporting requirements for some banks, which—from 2005—are required to both comply with

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<sup>24</sup> The ROSC team was unable to determine the number of limited liability and joint stock companies, which have subsidiaries, and the number of groups that are exempted from consolidation requirements.

<sup>25</sup> See Article 55 of the Accounting Act.

<sup>26</sup> Article 2.3 of the Accounting Act defines IFRS as only those standards that have been approved by the European Commission in accordance with Article 3 of Regulation 1606/2002.

<sup>27</sup> For convenience purposes, this report refers to “listed companies”. More accurately, it should refer to “issuers whose securities are admitted to trading on a regulated market”.

<sup>28</sup> See Article 45 of the Accounting Act.

<sup>29</sup> See Article 2 of the Act of August 27, 2004, which amends the Accounting Act.

<sup>30</sup> As set forth in Article 4 of Regulation 1606/2002.

<sup>31</sup> These include the Regulation on detailed accounting principles of banks, the Regulation on detailed procedures for the recognition of financial instruments, the measurement methods applicable to such instruments, the scope of their disclosure, and the manner of their presentation, and the Regulation on the principles of preparing consolidated financial statements of banks and financial holdings.

<sup>32</sup> See Articles 134.2 and 141g of the Banking Act.

*endorsed* IFRS in their consolidated financial statements and the Regulations issued by the Minister of Finance.<sup>33</sup> As illustrated in paragraph 56 below, the Regulations have not kept up pace with IFRS developments, which may result in an equivocal reporting platform.

18. **The Insurance Act of May 22, 2003, requires insurance companies to prepare financial statements in compliance with the Accounting Act and the Regulations issued by the Minister of Finance.**<sup>34</sup> Insurance companies are required to submit their annual financial statements to the Insurance and Pension Funds Supervisory Commission within six months of the year-end.<sup>35</sup> In addition, insurance companies are required to submit an additional annual financial and statistics report to the Insurance and Pension Funds Supervisory Commission no later than 15 days after the approval of the financial statements. Although the Regulations issued by the Minister of Finance have been updated based on the most recent changes to the EU Insurance Accounts Directive, the ROSC team also contemplates potential conflicting financial reporting requirements for listed insurance companies (see paragraph 57 below).

19. **The scope of statutory audit requirements generally results in the audit of financial statements only when there is a public interest requirement.** The Accounting Act requires that all 6,000 joint stock companies, all 3,800 large limited liability companies, banks, insurance companies, investment and pension funds be audited.<sup>36</sup> Large limited companies are those, which exceed two of the three following size thresholds: a total balance sheet of EUR 2.5 million, net annual turnover of EUR 5 million, and 50 employees. These thresholds effectively require that approximately 9,800 out of 106,700 Polish limited liability and joint stock companies and other regulated entities (e.g. banks, insurance companies, investment and pension funds, etc.) be audited by 3,950 practicing auditors. These thresholds are somewhat lower than those in the Fourth EU Company Law Directive (EUR 3.65 million total balance sheet, EUR 7.3 million income statement, 50 employees). However the total number of audits performed annually is approximately 20,000 including audits of consolidated financial statements, voluntary audits, and audits of other entities such as partnerships, foundations, and associations, etc.

20. **The Law on Auditors and their Self Governing Body dated October 13, 1994, as amended (the “Auditing Act”)** regulates the auditing profession in Poland. The Auditing Act is largely based on the Eighth EU Company Law Directive (1984).

21. **According to the Accounting Act,**<sup>37</sup> **shareholders appoint the statutory auditor annually unless the Memorandum of Association or other applicable regulations provide for otherwise.** In addition, unlike in certain EU Member States, the Accounting Act does not include any termination mechanisms that could provide additional safeguards to auditor’s independence. Hence, a statutory auditor may resign or be dismissed to avoid an audit qualification. The

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<sup>33</sup> Listed banks and banks operating within a capital group are given the option of also applying IFRS in their legal entity financial statements. For those banks that take this option, such a conflict is unlikely because the regulations of the Minister of Finance on specific accounting principles for banks would not apply to them. They would only be obligated to comply with the provisions of the regulation regarding rules for establishing reserves for risks associated with banking operations, for tax purposes.

<sup>34</sup> These include the Regulation on the preparation of quarterly and additional annual financial and statistical statements of insurance undertakings as well as the deadlines for the statements to be presented to the supervisory body, the Regulation on the preparation of consolidated financial statements of insurance undertakings, and the Regulation on the detailed accounting rules of insurance undertakings.

<sup>35</sup> See Article 167 of the Insurance Act.

<sup>36</sup> See Section 64 of the Accounting Act.

<sup>37</sup> See Article 64.4 of the Accounting Act.

Accounting Act provides for neither the rotation of a statutory auditor nor an audit firm.<sup>38</sup> However companies with State ownership are required to rotate the auditor or the audit firm every five years. Neither the Code nor the Act requires the statutory auditors to attend the annual shareholders' meeting or be available for questions by the shareholders.

**22. The law sets out additional legal requirements concerning audits of credit institutions and insurance, which do not appear to have any equivalent regarding audits of listed companies, investment funds, and pension funds:**

- **Contribution to prudential supervision.** The Accounting Act requires (a) a bank statutory auditor to opine on a bank's compliance with prudential requirements and the determination of the bank's solvency ratio; (b) an insurance company statutory auditor to opine on the company's technical and underwriting reserves, coverage of such reserves in compliance with prudential requirements and the determination of the company's solvency margin.
- **Mandatory Rotation.** The Insurance Act sets out a mandatory five-yearly rotation of the audit firm conducting a statutory audit of an insurance company.<sup>39</sup> This requirement does not appear to exist in the banking sector.
- **Matters of urgent interest to the regulators.** The Insurance Act requires that the statutory auditor of an insurance company communicate certain matters without delay to the Insurance and Pension Funds Supervisory Commission. These include violations of laws or regulations and deficiencies, which might threaten the solvency of the company. The Banking Act imposes similar requirements on bank statutory auditors but does add that the statutory auditor must inform the Banking Supervision Commission in the event that the statutory auditor intends to express an adverse opinion or a disclaimer of opinion.<sup>40</sup>
- **Appointment, dismissal, and resignation of statutory auditors.** The Insurance Act requires that an insurance company inform the Insurance and Pension Funds Supervisory Commission of the appointment/dismissal/resignation of a statutory auditor within seven days of such appointment/dismissal/resignation. The Commission does not have the authority to veto the appointment of a statutory auditor in an insurance company. This requirement does not appear to exist in the banking sector, either.

**23. The Accounting Act requires companies to file audited legal entity and consolidated financial statements with the Court Register.** No later than 15 days after the approval of the audited financial statements by the shareholders' meeting, the board of management must file the audited (consolidated) financial statements with the Court Register.<sup>41</sup> The Accounting Act requires statutory auditors to report any failure to file financial statements with the court register and to publish financial statements.<sup>42</sup> All companies subject to statutory audit requirements (see paragraph 19 above) are also required to publish an extract of their audited financial statements in the official gazette, *Monitor Polski B*.<sup>43</sup>

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<sup>38</sup> See paragraph 22 for an analysis of mandatory rotation in the banking and insurance sectors.

<sup>39</sup> See Article 170 of the Insurance Act.

<sup>40</sup> See Article 136 of the Banking Act.

<sup>41</sup> See Article 69.1 of the Accounting Act.

<sup>42</sup> See Article 65.3 of the Accounting Act.

<sup>43</sup> See Article 70.2 of the Accounting Act.

24. **Financial statements are available at the Court Register by paper means but not yet by electronic means.** Any interested person can obtain a copy of a company’s audited financial statements—including balance sheets, income statements, cash flow statements, changes in equity and reserves, notes to the financial statements and auditor’s reports—at the Court Register. However, because copies of financial statements are filed at local court registers and requesting a copy may require several visits to the register, the ROSC team found the financial statements not to be readily available. In addition, the Court Register currently lacks the authority to enforce filing requirements.<sup>44</sup> While the current system complies with the requirements of the First EU Company Law Directive (1968), the ROSC team determined that the existing filing and publication framework may not be fully leveraged by factoring companies, credit insurance companies, commercial banks, and the corporate sector in general when assessing and managing credit risk. The ROSC team also determined that the current system will need upgrading in accordance with the forthcoming requirements of the First EU Company Law Directive (amended in 2003).

25. **The Law on Public Trading of Securities (the “Securities Act”) and secondary legislation require listed companies to file annual, semi-annual, and quarterly legal entity and consolidated financial statements.**<sup>45</sup> The deadlines for submission of the reports of listed companies are as follows:<sup>46</sup>

Financial statements	Quarterly	Semi-annual	Annual
<b>Legal entity</b>	Within 35 days of the end of the period <u>except</u> the report for the last quarter (within 45 days of the year-end).	Within three months of the end of the period.	Within six months of the end of the year-end, and not later than 15 days <u>before</u> the annual meeting.
<b>Consolidated</b>	Within 45 days of the end of the period <u>except</u> the report for the last quarter (within 60 days of the year-end).	Within four months of the end of the period.	Within six months of the end of the year-end, and not later than 15 days <u>before</u> the annual meeting, and also not later than two months after the submission of the legal entity financial statements.
<b>Audit requirements</b>	Not applicable	Limited review of legal entity and consolidated financial statements.	Audit of legal entity and consolidated financial statements.

As noted above, Regulation 1606/2002 has already paved the way for a convergence of financial reporting standards throughout the EU for listed companies, which are required to prepare consolidated financial statements. The *acquis communautaire* (through the so-called “Transparency Directive”) only recently introduced more comprehensive half-yearly financial

<sup>44</sup> Deterrent incentives appear to be inadequate and a number of enterprises are reported not to file their financial statements, including economically significant domestic and foreign invested enterprises.

<sup>45</sup> See Article 81 of the Law on Public Trading of Securities and Article 93.1 of the Decree of the Council of Ministers dated March 21, 2005, on current and periodical information provided by issuers of securities.

<sup>46</sup> The deadlines apply only to listed companies, i.e., pension funds with publicly traded securities are not subject to the same deadlines. These are required to file their semi-annual financial statements within two months of the end of the first semester, and their annual financial statements within four months of the year-end.

reports for listed companies in order to allow investors to make a more informed and timely assessment of the issuer's situation.<sup>47</sup> The Transparency Directive, which should be transposed by Member States no later than January 20, 2007, requires listed companies to prepare and present annual financial report and half-yearly financial reports, including consolidated financial statements, within four months of the year and two months of the end of the semester, respectively. Poland will have to shorten filing deadlines in line with the Directive.

Also, different filing deadlines for legal entity and consolidated financial statements may result in a conflict with IAS 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*. IAS 27 effectively requires that the consolidated financial statements should be issued contemporaneously with the legal entity financial statements.

## B. The Profession

26. **The size of the accounting and audit profession has contracted slightly since the 2002 ROSC as evidenced by the membership of the two professional bodies that exist in Poland.** The National Chamber of Statutory Auditors (hereafter referred to as “KIBR”) has a membership of 7,547 (2002 – 7,700) and the Association of Accountant in Poland (AAP) has a membership of 29,322 ordinary members (2002 – >30,000) and 9,702 organizations (2002 – >12,000).<sup>48</sup> Of the 7,547 statutory auditors in Poland, some 1,115 (15%) completed the KIBR examinations, 46 (0.5%) entered with foreign qualifications and the remainder (84.5%) entered through the grandfathering scheme, whereby, chartered accountants in the AAP were able to register as statutory auditors and members of KIBR.

27. **In line with the *acquis communautaire*, the right to conduct statutory audits of financial statements is reserved for members of KIBR.**<sup>49</sup> KIBR estimates that of its total membership (7,547 members, see paragraph 26 above) only some 3,950 (52%) of its membership are currently practicing auditing. Among practicing auditors, there are approximately 2,000 audit firms registered, including 1,350 sole practitioners. In addition, the average age of statutory auditors is currently 59.

28. **Differences in technical proficiency of Polish auditors result in significant differences in audit quality.** Audit firms include local member firms of international audit firm networks, as well as local firms. Institutional investors, commercial banks, and other users of audited financial statements point to an uneven profession where a number of statutory auditors who were grandfathered into the profession in 1994 may not have been subject to the same professional qualification requirements as the more recently certified auditors. There is little empirical evidence to substantiate these views, and in fact, statutory auditors who were grandfathered into the profession underwent mandatory supplementary training and are currently subject to the same continuous education requirement as the new entrants to the profession. Still, the public seems to perceive that the quality of a significant portion of the profession may not

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<sup>47</sup> See Directive 2004/109/EC of the European Parliament and of the Council dated December 15, 2004, on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC.

<sup>48</sup> Membership of the Association of Accountants in Poland is voluntary and the association is not authorized by Government to issue any professional certificates. However, the AAP plays an important role in the delivery of the KIBR professional training and continuing professional education.

<sup>49</sup> Although the KIBR qualification is currently not “internationally” recognized, the completion of KIBR exams provides exemptions from 11 of the UK’s ACCA papers. It is therefore a reasonable option for a student to first qualify with the KIBR and then ACCA, if they wish to obtain a qualification more “internationally” recognized.

meet generally accepted professional qualification criteria. This perception is harmful and jeopardizes the contribution of statutory audits to a well-functioning market economy, as an audit's value is based on the user's confidence. The policy recommendations in Section VI stress that the present situation requires further initiatives to enhance public trust in the audit function in Poland.

29. **The mandate of KIBR does not explicitly include serving the public interest.** The duties of KIBR, as defined by the Auditing Act,<sup>50</sup> include representing the members of the Chamber and protecting their professional interests. However, the mandate of a professional association of auditors should not so much be to defend themselves, but rather the public interest. Hence, the Auditing Act should make it the explicit duty of KIBR to serve the audit profession's public, which consists of clients, credit grantors, governments, employers, employees, investors, the business and financial community, and others who rely on the objectivity and integrity of auditors to maintain the orderly functioning of commerce.

30. **KIBR issued an updated Code of Professional Ethics for Statutory Auditors, which is based on the translation of the International Federation of Accountants (IFAC) Code of Ethics for Professional Accountants (November 2001) in June 2002.** However, this code does not include either a definition of the features of a public interest profession or a definition of a public interest. The Law and the Code of Ethics establish the principle that a statutory auditor must be independent in his or her professional activity. However, neither the Law nor the Code of Ethics prevent auditors from accepting non-audit work from audit clients, including internal audit services, executive recruiting, investment advice, tax consultancy and other expert services unrelated to the audit, with the proviso that this should not infringe on the independence of the statutory auditor. In some instances, the ROSC team met with auditors and preparers of financial statements, who admitted to the fact that statutory auditors prepare financial statements contemporaneously with the statutory audit. While a breach of generally accepted independence requirements, the ROSC team noted that this situation resulted from an acute lack of professionally trained accountants. The ROSC team is worried that this issue may be compounded by the 2005 requirement to use *endorsed* IFRS in preparing consolidated financial statements of listed companies.

31. **The Auditing Act recognizes the profession as self-regulated and independent though subject to the supervision of the Ministry of Finance.** The Ministry of Finance is responsible for the supervision over KIBR.<sup>51</sup> The bodies of KIBR are obliged to submit adopted resolutions to the Ministry of Finance within 30 days from the date of their approval. The main governing body of KIBR is the National Assembly of Statutory Auditors, which is held every four years.<sup>52</sup> The National Assembly of Statutory Auditors consists of delegates from the regional branches of KIBR, elected during general meetings, in proportion to the overall number of Statutory Auditors from the register, in accordance with the principles settled by the National Council of Statutory Auditors. The National Council of Statutory Auditors manages the activities of the self-governing body in periods between the National Assemblies of Statutory Auditors.<sup>53</sup> The other bodies of KIBR are:

- The National Internal Audit Committee
- The National Disciplinary Court

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<sup>50</sup> See Article 20 of the Auditing Act.

<sup>51</sup> See Article 30 of the Auditing Act.

<sup>52</sup> See Article 22 of the Auditing Act.

<sup>53</sup> See Article 25 of the Auditing Act.

- The National Disciplinary Spokesman
- The National Supervisory Committee

The current self-regulatory regime does not conform to the requirements set out in the proposal for a new Eighth EU Company Law Directive. For example, the European Commission sets out that the system of public oversight must have the ultimate responsibility for the oversight of the approval and registration of statutory auditors and audit firms, the adoption of standards on ethics, internal quality control of audit firms and auditing, and continuous education, quality assurance and investigative and disciplinary systems.

32. **Existing legal civil and criminal provisions relating to auditors' liability do not appear to establish a strong deterrent.** The main issues concerning the current Polish legislation of directors' and auditors' activities include the following:<sup>54</sup>

- **Although the Accounting Act also provides for criminal liability of auditors who issue an audit opinion that "does not agree with the facts", with penalties of a fine or two years prison or both,<sup>55</sup> there is no evidence that an auditor has ever been prosecuted under these provisions.**
- **The Civil Code provides for a civil liability mechanism and the Auditing Act requires statutory auditors to maintain professional indemnity insurance.<sup>56</sup>** A statutory auditor or an audit firm is liable for the obligation arising from the audit contract. Statutory auditors and audit firms are required to take out a professional indemnity insurance policy of at least EUR 45,000.
- **KIBR is responsible for imposing disciplinary sanctions.** In the event of a violation of the Auditing Act, the standards on auditing recognized in Poland or the code of professional ethics, KIBR may initiate a disciplinary matter on its own initiative, pursuant to a proposal from a court or to a complaint from a third party. Disciplinary sanctions include an admonishment, a reprimand, a suspension of the statutory auditor's certificate for a period between one and three years, or a cancellation of an auditor's certificate. However, the deliberations and findings of the National Disciplinary Court are confidential and not in the public domain.

Figures provided by KIBR showed that 81 cases heard by the National Disciplinary Court in the 18 months to October 2004 resulted in six reprimands and four suspensions but no de-registrations or further actions.

Two issues stand out here; (a) the low number of sanctions suggests a high degree of leniency and (b) the secrecy of the proceedings minimize the deterrent effect of the National Disciplinary Court and are likely to engender public distrust of the profession which may be seen as self serving and not acting in the public interest.

33. **There is a lack of transparency of audit firms and networks and the relationship between the local firms and their network.** Transparency should be a natural requirement for audit firms, which fundamentally operate to ensure the transparent financial reporting by companies. Trying to discern the internal quality assurance arrangements of audit firms, the ROSC team was unable to obtain adequate information, including what local member firms

<sup>54</sup> This report outlines the legal principles applicable with regard to each of auditors' liability and does not attempt to give anything more than an introduction to the issues. This report is not meant to be an exhaustive rendition of the law nor is it legal advice to those reading it.

<sup>55</sup> See Article 78 of the Accounting Act.

<sup>56</sup> See Article 12 of the Auditing Act, and defined by Decree of Minister of Finance dated December 2, 2003.

belong to international audit firm networks, the size of the audit firm, the owners and management members of the audit firm, the network's membership or the basis for partner remuneration.

34. **In addition to statutory audit, providing external bookkeeping services is also a regulated activity in Poland.** The Accounting Act sets out that the Minister of Finance determines the qualifications and other requirements to be met to be authorized to provide external bookkeeping services. In this regard, the Minister appoints an Examination Board responsible to review the qualifications of the candidates. Successful candidates receive a "bookkeeping certificate" if, among other things, they have (a) three years of professional experience in bookkeeping and hold a master's degree in accounting; or (b) two years of experience in bookkeeping and hold a secondary school education certificate, and have passed a professional examination organized by the Examination Committee established by the Minister of Finance. A foreign accountant may be authorized to render bookkeeping services in Poland subject to passing an aptitude test or having relevant practical experience. While the ROSC team wholeheartedly supports the development of a robust accounting profession in Poland, the ROSC team would be concerned if the country wanted to maintain the existing state regulation of bookkeeping services in the long run. There is a clear trend away from such regulation, as evidenced by the recent debate on the *acquis communautaire* (Chapter VI - Competition Policy).<sup>57</sup>

### C. Professional Education and Training

35. **The certification of statutory auditors is largely based on the Eighth EU Company Law Directive of April 10, 1984, regarding the approval of statutory auditors of financial statements.**<sup>58</sup> A prospective auditor must be someone who, among other things:

- Has a Polish degree, or foreign degree recognized in Poland and is fluent in the Polish language, both written and spoken;
- Has a three-year practice experience in Poland, including at least two-year practice under an auditor's supervision and has been confirmed by the Examinations Committee of KIBR;
- Has passed, before the Examinations Committee, auditing exams;<sup>59</sup> and
- Has been granted the diploma of a Statutory Auditor.

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<sup>57</sup> For further details, see "Economic Impact of regulation in the field of liberal professions in different EU Member States", Ian Paterson, Marcel Fink, Anthony Ogus, Institute for Advanced Studies, Vienna, January 2003 (available at: <http://europa.eu.int/comm/competition>).

<sup>58</sup> It should be noted that although the Eighth EU Company Law Directive (1984) contains some requirements on registration and professional integrity, it does not include requirements on how a statutory audit should be conducted and the degree of public oversight or external quality assurance which is needed to ensure a high-quality audit. The lack of a harmonized approach to statutory auditing in the EU was the main reason behind the Commission's proposal for a new Eighth EU Company Law Directive (March 2004), which maintains the basic conditions on education and training from the existing Directive but broadens the scope of application of EU legislation by introducing new requirements concerning the manner in which an audit should be carried out and the structures needed to ensure audit quality as well as ensure trust in the audit function. As of the date of this report, the new Eighth EU Company Law Directive has not yet been passed by the European Council and Parliament.

<sup>59</sup> The professional examination covers subjects mandated by the Eighth EU Company Law Directive (1984) and is handled by the Examination Committee of KIBR.

36. **Persons who possess qualifications to practice as an auditor granted in European Fair Trade Association (EFTA) and the European Economic Area (EEA) countries may become statutory auditors after passing an Economic Law exam in the Polish language<sup>60</sup>.** The provisions regarding auditors from EEA countries are fully in line with Article 14 of the proposed new Eighth EU Company Law Directive. The proposed Directive contains no special provisions for auditors from EFTA countries who would fall under the provisions of the proposed Article 44, which allows for approval of auditors from other countries. Article 44 stipulates that on condition of reciprocity the competent authorities of a Member State may approve auditors from a third country. The Auditing Act is silent on the matter of reciprocity and may therefore not conform to the proposed Directive.

37. **There are no official KIBR study materials available for students.** Training classes are mainly run by the many regional branches of the KIBR and in Warsaw by the AAP. It is likely there is a need for improving the curriculum of professional education and the system of professional examination for statutory auditors. These improvements should be made with reference to International Education Standards issued by IFAC, as well as the Eighth EU Company Law Directive.

38. **The practical experience/training of individual candidates needs to be approved by the Examination Committee of KIBR.** In special cases, KIBR may waive the one-year accounting work experience; however, the two-year professional experience requirement cannot be waived.

39. **The professional qualifications are beginning to be integrated with university education, providing an educational continuum.** The Auditing Act<sup>61</sup> provides that “at the candidate’s request, the Committee may grant the candidate exemption from examination subjects, if the candidate has passed these subjects at the university or a synonymous institution during the period of three years before the date of filing the request,” and completion of the Warsaw School of Economics courses in Cost and Management Accounting; Financial Accounting; Economics and Management; Civil, Labor and Commercial Law; Tax Law; and Finance can earn an exemption from two KIBR papers.

40. **Statutory auditors are obliged to undergo continuing professional education (CPE) for at least 30 hours a year or 60 hours over two years, and statutory auditors not practicing the profession (not conducting audits of financial statements) for at least 15 hours a year or 30 hours over two years. Required courses are defined annually by the National Council of Statutory Auditors which adds new issues to the list of topics and removes old issues from this list.** Trainers must be approved by and registered with the KIBR. The registered trainers inform the Council of the dates of seminars and ensure that persons delegated by the Council to conduct inspection visits can carry them out. After the training has been completed, the training entities forward to the Council the list of participants that have completed the obligatory training. Practitioners must only include courses on the defined list, delivered by defined trainers within their annual 30 hours of CPE.

41. **Records of persons who have completed training are kept by the KIBR, which monitors compliance with the training requirements.** Persons not fulfilling the training requirements are referred by the Council to the National Disciplinary Spokesman, who institutes disciplinary procedures. However, disciplinary sanctions are not in the public domain.

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<sup>60</sup> See Article 5 of the Auditing Act.

<sup>61</sup> See Article 8 of the Auditing Act.

#### D. Setting Accounting and Auditing Standards

42. **As a Code Law country the majority of accounting requirements are contained in the Accounting Act rather than in Accounting Standards.** The principal Polish accounting regulations consist of the Accounting Act; Decrees from the Ministry of Finance concerning accounting by banks, insurance companies, investment funds, pension funds, consolidation and financial instruments; and two Polish Accounting Standards concerning cash flow statements and deferred taxation that have been issued to date by the Polish Accounting Standards Committee (ASC). The Accounting Act mandated the Ministry of Finance to establish the ASC. The ASC was established in April 2002,<sup>62</sup> its main task being the issuance of Polish Accounting Standards independently from tasks performed by the Ministry of Finance. The ASC should provide a forum for exchange of views on the most problematic issues that appear during the process of change in the national accounting system.

43. **The ASC comprises a broad range of stakeholders but lacks preparers and users of financial statements.** The ASC is financed by the Ministry of Finance from the state budget. The Secretary, who is at the same time a full-time employee of the Accounting Department in the Ministry of Finance, provides all administrative service to the ASC. The ASC consists of 18 members, of whom:

- One is appointed by the Minister of Treasury (must be a staff member);
- One by the Securities and Exchange Commission (must be a staff member);
- One by Chairman of the National Bank of Poland (must be a staff member);
- Five by the AAP (two of them must have academic titles);
- Five by the KIBR (three of them must be practicing statutory auditors representing audit firms), and
- Five by the Minister of Finance (three of them must be staff members).

The ASC may not include enough persons with extensive experience in preparing and analyzing financial statements in order to reflect the broad range of interests affected and understand the practical implications of the ASC's decisions.

44. **With respect to its authority, the ASC does not appear to have the authority, or at least the duty, to review accounting issues that are likely to receive divergent or unacceptable treatment in the absence of authoritative guidance under Polish Accounting Standards, with a view to reaching consensus as to the appropriate accounting treatment.** In the absence of such mechanisms, preparers generally turn to the audit profession to develop interpretations. As recent international scandals have demonstrated, relying solely on the audit profession, at a time where accounting principles allow for interpretations ranging from the conservative to aggressive, may need to be revisited.

45. **Accounting standards for banks and insurance companies are supplemented by certain Regulations issued by the Minister of Finance.** The Minister of Finance issues prudential regulations that have an impact on the preparation of general-purpose financial statements (see paragraphs 17 above and 18 above).

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<sup>62</sup> Pursuant to the Decree of the Minister of Finance dated November 28, 2001, on the Scope of Operation and the Organization Method of the Accounting Standards Committee.

46. **KIBR is legally authorized to set auditing standards. KIBR sets auditing standards in consultation with the Ministry of Finance and the Polish Securities and Exchange Commission (hereafter referred to as “KPWIG”), and in relation to banks after consultation with the Banking Supervision Commission.** When drafting auditing standards, efforts are made to adapt internationally recognized standards to country circumstances. To date, KIBR has issued five auditing standards:

- Standard 1 –auditing (legal entity) financial statements;
- Standard 2 –auditing financial statements of entities of the financial sector (banks, insurance companies, pension and investment funds, etc.);
- Standard 3 – auditing consolidated financial statements;
- Standard 4 – limited review of financial statements; and
- Standard 5 – principles of conduct of entities authorized to audit financial statements and perform other attestation services.

If particular auditing issues are not covered by the local standards, KIBR requires the use of appropriate International Standards on Auditing.

47. **Poland plans to accept as binding the International Standards on Auditing in whole.** In principle, this requirement should be consistent with the proposal by the European Commission to require the use of “endorsed” International Standards on Auditing (i.e., ISA adopted by the European Commission) as a requirement for all EU statutory audits beginning 2007 onwards.

#### **E. Enforcing Accounting and Auditing Standards**

48. **KPWIG is currently implementing the fundamental principles set out in Standard No 1 on Financial Information, *Enforcement of Standards on Financial Information in Europe, of the Committee of European Securities Regulators (CESR).***<sup>63</sup> Significant progress has been made in implementing the principles of Standard No 1 and KPWIG attends CESRfin<sup>64</sup> committee meetings as the national securities regulator. KPWIG, the Banking Supervisory Commission, and the Insurance and Pension Funds Supervisory Commission also attend the extended sessions of the CESR Sub-Committee on Enforcement, which is a forum to which all EU national enforcers of financial information are invited. The purpose of these sessions is to invite discussion of national individual enforcement issues and to facilitate debate on wider matters of common interest to enforcers of IFRS with a view to achieving harmonization of enforcement practices and convergence of IFRS application. Participation in these sessions, as established by CESR Standard No 2 on Financial Information, *Co-Ordination of Enforcement*

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<sup>63</sup> CESR was established under the terms of the European Commission’s Decision of 6 June 2001 (2001/527/EC). In summary, the role of CESR is to improve coordination among securities regulators, act as an advisory group to assist the EU Commission, and ensure more consistent and timely day-to-day implementation of community legislation in the Member States. CESR issues guidelines, recommendations and standards that the CESR members introduce in their regulatory practices on a voluntary basis.

<sup>64</sup> CESRfin is a permanent operational group with the role of coordinating the work of CESR members in the area of endorsement and enforcement of financial reporting standards in Europe. CESRfin enables CESR to play an effective role in the implementation and enforcement of the IFRS in the EU. To deliver the objectives outlined above, CESRfin has established three sub-committees: The Sub-committee on endorsement of IFRS (SISE), the Sub-committee on Enforcement (SCE) and the Audit Task Force.

*Activities*, provides enforcers with additional and valuable resources and will be of particular assistance to KPWIG as it builds up its IFRS enforcement regime.

49. **A review of the extent to which KPWIG complies with the CESR Standard No. 1 on Financial Information gives rise to the conclusion that although considerable effort is being made to demonstrate commitment to the core principles, further work is needed to ensure that monitoring can be conducted at a level and intensity to provide a system that is capable of meeting the more exacting demands of enforcement within the framework of principle-based IFRS.**<sup>65</sup> Against the evidence of the efforts made to introduce enforcement arrangements that are compliant with the principles of CESR Standard No 1 on Financial Information, the following should be noted:

- ***Principle 5 – Irrespective of who carries out enforcement any standard on enforcement established by CESR should be complied with.*** The Banking Supervisory Commission (BSC) and the Insurance and Pension Funds Supervisory Commission (IPFSC) are charged with the prudential supervision of banks, insurance companies and pension funds.<sup>66</sup>

Article 133 of the Banking Act states that the purpose of BSC’s supervision is to ensure the security of cash means accumulated on bank accounts and the compliance of banks activities with the provisions of the Banking Act. It is not a stated function to act to protect the interests of investors, a primary objective of an enforcer of financial information under CESR Standard No 1 on Financial Information (although this could be argued to be implicit). BSC is empowered to, inter alia, “assess the financial position of banks, including their financial results.”

Considering the minimum powers and characteristics required by CESR Standard No 1 on Financial Information, BSC has a positive impact in respect of the monitoring and enforcement of financial information required in respect of the financial statements of banks:

- **BSC monitors compliance with the accounting, reporting and auditing requirements for banks through on-site inspections.** BSC may open an investigation into a bank’s financial statements either because it is alerted to a potential qualification or other specified activity by an auditor or has concerns arising from its ongoing supervision. BSC’s investigation could involve the consideration of accounting principles in respect of the banking sector generally and the individual circumstances of an entity.

Specifically, an investigation is triggered by a qualified audit report, which is required to be notified to BSC prior to signature. Anecdotal evidence suggests that there are no qualified audit reports in respect of banks, indicating the effectiveness of BSC’s intervention on the preparation of compliant financial statements.

- **Banks are obliged under the law to provide BSC with access to documents and with information to satisfy the examiners’ enquiries.** Banks are required to enable “authorized persons” to provide BSC with

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<sup>65</sup> There are approximately 140 companies listed on the Warsaw Stock Exchange, which have subsidiaries, and are therefore required to prepare IFRS consolidated financial statements beginning in 2005.

<sup>66</sup> Whether they enforce the accounting framework as set out in CESR Standard No 1 on Financial Information, i.e. whether they may be regarded as “independent administrative authorities”, is a matter for CESRfin (SCE) to determine.

relevant documents. This obligation does not appear to extend in law to auditors.<sup>67</sup>

- **Banks are also obliged to inform BSC of measures taken to eliminate irregularities discovered through supervision and to comply with the decisions and recommendations of the BSC.** This would appear to include accounting matters.

There are two considerations however that raise a question whether BSC is a national enforcer of the accounting framework in the terms envisaged by CESR Standard No 1 on Financial Information:

- **First, any improvements in the quality of financial reporting that BSC may bring about appear to be a by-product of its prudential supervisory responsibilities.** Standard No 1 makes clear, for example, that the request for further information from auditors and management must be made with the aim of enforcing the reporting framework for financial information. The procedures BSC can instigate in respect of breaches of the standards and limits specified by the Banking Act are sanctions imposed by national legislation designed to penalize. Actions as described in Standard 1 are “measures generally aimed at improving market integrity and confidence.”

BSC does not have the power to require a bank to make a public statement or correction of its financial statements. Agreements exist however that would allow BSC to report such cases to KPWIG for consideration and which could include the requirement to publicize the breach.

Notwithstanding these caveats, the monitoring function of BSC presents a positive enforcement mechanism for the financial information required of banks, including those that are listed. There is a question whether this level of active monitoring will continue to be effective under IFRS where listed banks may elect to present their legal entity financial statements in accordance with Polish accounting requirements, leaving an information gap between the consolidated and legal entity financial statements that may reduce BSC’s effectiveness as an enforcer of financial information.

- ***Principle 6 – Competent administrative authorities shall have adequate independence from government, and market participants, possessing the necessary powers and having sufficient resources.*** As an administrative body of central Government, the structure and funding of KPWIG are under Government control to the following extent. The activities of the Commission are overseen by the Minister of Finance. The President of the Council of Ministers appoints a Chairperson to KPWIG on the recommendation of the Minister for a five-year term. The Chairperson is supported by seven Members – two of whom are representatives of other Ministries (Treasury and Ministry of Finance). The Bank of Poland, the Competition and Consumer Protection Office, and IPFSC are also represented. The Minister determines the level of fees levied against listed companies and which fund KPWIG. He also determines the principles that govern remuneration levels of KPWIG. However, although directly under the control of the government, and reporting to it, KPWIG appears to operate without political interference in its enforcement of financial information.
- ***Principle 8 – The competent administrative authorities should be responsible for (a) the setting up of an appropriate due process of enforcement consistent with the***

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<sup>67</sup> See Article 139 of the Banking Act.

***application of the principles hereby stated; and (b) the implementation of that due process.*** Historically, KPWIG have reviewed the financial information in accordance with the requirements of the Securities Act and supplementary Decrees. KPWIG has not established a special review form to be applied for revising the financial statements of listed companies.

This implies a procedural approach to the checking of disclosure for evidence of consistency with the accounting requirements of the Securities Act, including Polish Accounting Standards or IFRS where applied (see paragraph 15 above).

From January 1, 2005, the reviewing of financial statements for compliance with principles-based IFRS in relevant financial statements will inevitably be more demanding of the skills required by reviewers, given the reduction in prescription and the perceived increase in flexibility in determining appropriate accounting treatments. The development of an IFRS decision database, confidential to EU national enforcers through CESRfin (SCE) should assist convergence in this regard.

- ***Principle 11 – For financial information other than prospectuses ex-post enforcement is the normal procedure, even if pre-clearance is not precluded.*** KPWIG review prospectuses on an ex-ante basis and other harmonized financial information ex-post. KPWIG also provide issuers with oral or written opinions on the applicability of specific accounting treatments but this is not considered by KPWIG to constitute pre-clearance of accounting treatments to be included in annual or periodic reports.

As CESR Standard No 1 incorporates pre-clearance as enforcement decisions, KPWIG should consider carefully before providing such opinions as to whether it is in a form on which the issuer is entitled to rely in its financial statements. The provision of such assistance is likely to become more prevalent in the short-term as issuers consider the impact of IFRS on their historic accounting treatments. If issuers can rely on such guidance, the monitoring and enforcement of standards as adopted in published financial statements may be more problematic to enforce if issuers have based their adoption on assistance by KPWIG, which might not have been in possession of all the relevant facts and circumstances of the case.

- ***Principle 14 – In order to allow enforcers to adopt gradually the selection methods provided for by Principle 13, a mixed selection technique based on a combination of a random selection and rotation is considered a workable transitional step. However, such a methodology should be designed to give an adequate level of detection risk.*** KPWIG reviews information for timely preparation within the limits specified in the Securities Act and whether the content is as required by the Law and additional Decrees. Recently, these reviews have not been conducted as the information has been received but subsequently when resources permit.

Selection of financial information for review is not currently conducted on a risk-based approach. However, recent reviews have demonstrated a need to consider compliance with accounting requirements across the full range of listed companies. KPWIG is aware of the need to introduce a risk-based approach to its procedures and is seeking guidance on how it might achieve this effectively and efficiently, bearing in mind the other demands on the relevant department. CESRfin (SCE) has a sub-group currently working on further guidance on how a risk-based strategy might be applied but this is in early stages and little has yet been shared with the main members of the Committee.

The recent inter-divisional reorganization at KPWIG has, as a result, that staff responsible for monitoring financial information will be working more closely with

those who review the markets, encouraging a more “joined up” approach to regulation and which could facilitate a risk-based approach.

As most issuers prepare their financial statements to the same year-end, it is critical to KPWIG’s budget and planning process that a risk-based selection method ensures that those financial statements with a higher degree of potential misstatement are reviewed on a timely basis.

A screening mechanism for qualified audit reports is a high priority to ensure that enforcement action is taken in respect of issuers who do not prepare their financial statements in accordance with the relevant requirements. Such breaches should be investigated and, where appropriate, enforcement action should be seen to be taken. This could have a significant impact as a deterrent to the preparation of non-compliant financial statements.

- ***Principle 16 – Where a material misstatement in the financial information is detected enforcers should take appropriate actions to achieve an appropriate disclosure and where relevant, public correction of misstatement (in line with the requirements of the reporting framework). Non-material departures from the reporting framework will not normally trigger public correction even though they normally deserve an action as well. Materiality should be assessed according to the relevant reporting framework.*** The Accounting Act provides for criminal liability for non-compliance with relevant accounting, reporting and auditing requirements (see paragraphs 11 and 32 above).

The Securities Act was recently amended to provide KPWIG with further powers. Specifically, Article 85 provides for fines of up to PLN 500,000 (equivalent to approximately EUR 122,500) in respect of breaches of Article 81 and which includes the provision of current and periodic financial information. KPWIG can also exclude the issuer from trading.

At least three listed companies were fined between March and November 2004 for not properly providing periodic or continuing information. There were no reported instances of companies being required to publish corrective information in newspapers. The inference is that the fines relate to companies that produced incomplete or untimely information rather than those that include a material inappropriate accounting treatment but this was not possible to ascertain.

Confidentiality restrictions, only recently lifted, precluded KPWIG in the past from disclosing any further details of their enquiries. The ability to explain the matters at issue provides KPWIG with a valuable tool with which to inform issuers of enforcement decisions taken in respect of accounting treatments. It also facilitates full participation in the coordination of enforcement activities across the EU as set out in CESR Standard No 2 and which depends on the mutual exchange of information with fellow EU national regulators.

- ***Principle 17 - Actions taken by the enforcers should be distinguished from sanctions imposed by the national legislation.*** It is suggested that, in the absence of specific provisions in the Securities Act on a monitoring mechanism and function, compliance is ensured by the audit function and the requirement to file financial statements with the relevant court register (see paragraph 23 above). There is no mechanism for ensuring that the financial statements laid with the court register are amended for the breach in respect of which companies have been found not to comply, even where the suspected breach is proven and public announcement is made. This means that the public, in accessing such financial statements – and evidence suggests that they do so in some reasonable numbers – are not being

presented with current or restated financial information compliant with the accounting or reporting requirements.

KPWIG has no power to require an issuer to re-present its financial information following enquiry and establishment of a material breach – although it is said that the company is at liberty to do so. This presupposes a provision in law that enables issuers to voluntarily recall financial information and correct it for the breaches.

KPWIG can, however, require the issuer to publish the corrected information in two national daily newspapers. The effectiveness of this manner of public notification is questionable. It presupposes that users, including investors and potential investors take note of the publication; it assumes that the form of the disclosure is sufficient to enable the reader to appreciate the nature of any accounting deficiency and its impact on the financial statements and the impact it has on any investment decision. It is also a mode of announcement that may lend itself to misclassification, but may not be appropriate in cases where an accounting treatment has been found to be wanting and where the means of correction in a manner that is both comprehensive and understandable may exceed the boundaries of what might reasonably be disclosed in the financial press.

A power to require a company to issue a public announcement and to reissue and re-file its financial statements where they are found to be in breach of financial reporting requirements would:

- Ensure that the public have access to financial information that is properly prepared in accordance with the accounting provisions.
- Act as a further deterrent to issuers from publishing non-compliant financial statements.
- ***Principle 18 - Actions should be effective, timely enacted and proportional to the impact of the detected infringement.***

Without access to the detail of enquiries conducted by KPWIG the timeliness of measures is difficult to assess.

50. **KPWIG may need additional resources to ensure that it is fully geared to enforce IFRS.** It is clear from the evidence gathered by the ROSC team that, in the last months, the priority of the KPWIG has, properly, been to ensure the timely and effective introduction of legislation necessary to implement the *acquis communautaire*. While considerable effort appears to have been expended in ensuring that the relevant laws and regulations are in place, this has diverted already scarce resources from the monitoring and enforcement function of the KPWIG. Monitoring of financial information has been conducted when spare capacity was available rather than as a continuing obligation. Performing monitoring activities when capacity permits rather than when financial information is presented to the market gives rise to the risk that enforcement action, if appropriate, may not be taken on a timely basis; and the market is not informed of defective information or of the correct information to which it might respond—an outcome that runs counter to a key aim of the KPWIG to protect the interests of investors and potential investors.

51. **KPWIG does not currently enquire into the financial statements of issuers that present financial information that has been qualified by the statutory auditor.** The view appears to be that, where there is an audit qualification, the market can rely on the additional disclosures and explanations presented in the audit report and which investors can take into account when considering the veracity of the financial information. This approach is more consistent with a “comply or explain” regime rather than where compliance with accounting

standards is required by law and is required to be supported by the availability of appropriate enforcement actions. A qualified audit report is the clearest indicator that accounts are not compliant with the required legislation but KPWIG does not recognize this as a prompt to pursue to enquiry and to take appropriate enforcement action.

52. **The banking sector is a marked exception to the general lack of compliance.** Not a single incidence of a qualified audit report was found in the banking sector. The role of the National Bank of Poland (NBP) in exercising prudential overview incentives banks to comply with accounting regulations. The Insurance and Pension Funds Supervisory Commission performs a similar role for the insurance and pensions sector.

53. **The statutory regulatory bodies rely heavily on the auditors for ensuring compliance with accounting standards but there is a high incidence of qualified audit opinions indicating a high level of non-compliance by reporting enterprises.** The statistics available from KIBR indicate that the percentage of audits resulting in qualified audit opinions has been rising slowly since 2000 and is currently at about 8.6%. One small audit firm informed us that in 2003 more than half of the audit opinions it produced were qualified in some way. Although this may suggest that many auditors are carrying out their work as honestly as possible, it also supports many comments that there is a lack of understanding of technical accounting issues within reporting entities, leading to a high degree of non-compliance with accounting standards.

54. **In June 2002 the members of the National Supervisory Committee (NSC) were elected by the Extraordinary National Assembly of Statutory Auditors. NSC has the remit of ensuring that statutory auditors are practicing with due care and in compliance with auditing procedures.** The Committee cooperates with 100 inspectors to carry out reviews of audit firms who can expect a visit at least every three years. The intention is to match the inspectors' professional experience with the portfolio of the audit firm to be reviewed. The NSC has developed standard review checklists to cover the review. There reviews are carried out at the level of the firm and at the level of the detailed audit procedures carried out by the firm. Inspectors determine the number of audit files that need to be reviewed in order to properly carry out their inspection. A cross section of different types of assignments is reviewed.<sup>68</sup> The main conclusions reached by the ROSC team were:

- ***The quality assurance regime focuses on statutory auditors and audit firms.*** All members of KIBR, including those employed in audit firms, are subjected to the NSC's quality assurance system. The procedures carried out appear to be well designed and in line with what used to be accepted practice in EU Member States.
- ***The quality assurance system does not have adequate public oversight.*** The overall system lacks adequate public oversight. KIBR keeps all information confidential so that not even members of the auditing profession are aware of the extent of disciplinary activity. Consequently, the Polish quality assurance systems do not have the credibility to sustain public confidence and demonstrate the adequate discharge of self-regulating responsibilities.
- ***Confidentiality arrangements may need to be enhanced.*** The Auditing Act on Auditors makes it clear that disclosure of client information does not breach

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<sup>68</sup> Since the NSC inception, 423 audit firms were visited in 2003 and 803 in 2004. During the period of June 2003 to December 2004, 210 motions for initiating disciplinary proceedings were made to the National Disciplinary Court; seven of which requested exclusions from the profession. Currently, KIBR keeps confidential the results of practice review.

confidentiality in the case of pending legal proceedings before the governing bodies of KIBR. However, it is not clear whether the provision overriding the auditor's duty of confidentiality is broad enough to permit NSC to conduct a routine quality review.

- ***Decisions of the National Disciplinary Court should be in the public domain.*** In order to engender public trust for the profession the disciplinary decisions should be made public.

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

55. **While recent Polish accounting requirements are generally in line with the Fourth and Seventh EU Company Law Directives, certain differences with IFRS may impede the reliability of financial statements in public interest entities.** As discussed in paragraph 14 above, Polish accounting requirements (PARs) are generally in line with the Fourth and Seventh EU Company Law Directives. These accounting requirements are generally adequate for SMEs. However, some fundamental differences with IFRS exist and Polish accounting requirements may not always provide the general public with sufficient information about *public interest enterprises*. Selected differences include the following.<sup>69</sup>

- ***Property, plant, and equipment (PPE) may be under or overstated.*** PARs fall short of IFRS and may result in under/overstatement of PPE:
  - ***Measurement at recognition.*** PARs do not specifically require that the initial measurement of PPE includes the estimated cost of dismantling and removing an item and restoring the site (e.g., nuclear plant, restoration of a quarry, clay pits, etc.). This may result in an understatement of the related provisions for decommissioning and other environmental costs.<sup>70</sup>
  - ***Measurement after recognition.*** Revaluations are carried out only when required by the Minister of Finance. The last revaluation took place on January 1, 1995 when fixed assets—other than land—were revalued with either use of market values or adjusted by inflation indices calculated specifically for each major category of assets. Although Poland was regarded hyperinflationary in 1995 and 1996, assets were not revalued. This may result in an understatement of PPE and related depreciation expenses.
- ***Lease accounting could mislead users.*** PARs provide definitions of the lessor and the lessee in a manner that is substantially consistent with IFRS. However, PARs do not provide any further guidance on issues such as measurement, revenue recognition, and sale and leaseback transaction.<sup>71</sup> Consequently, as indicated in paragraph 15 above, companies may but do not have to, refer to IAS 17, *Leases*, to account for a lease. A company may therefore elect to recognize immediately gains on a “sale” transaction in circumstances where IFRS would not allow immediate recognition of the gains (e.g., if a sale and leaseback transaction results in a finance lease).

<sup>69</sup> This analysis draws on *International Accounting Standards: Similarities and Differences – IAS, US GAAP, and Polish Accounting Regulations*, PriceWaterhouseCoopers, 2002, updated as at October 2004.

<sup>70</sup> PARs include a general requirement consistent with IFRS based on which some auditors—but not all—require that a provision be recognized.

<sup>71</sup> Sale and leaseback transactions involves a transaction where the owner of an asset (seller-lessee) sells the asset and the immediately leases it back from the new owner (buyer-lessor). These transactions may occur when the seller-lessee is experiencing cash flow or financing problems or for tax reasons.

- **Provisions for employment benefits may be understated.** IFRS-compatible accounting requirements for employee benefits do not exist.<sup>72</sup> While pension schemes that are based on defined benefits are non-existent, there are other benefits such as jubilee bonuses paid by some entities to employees, usually every five years, or one-off retirement payments obligatory for all companies. Significant understated provisions may occur in larger, (formerly) state-owned enterprises where employees have longer periods of employment history.
- **Capitalized foreign exchange losses may overstate PPE.** PARs provide that the cost of purchase or manufacture of tangible fixed assets comprises the total costs incurred by an enterprise in relation to the period of construction, including related foreign exchange differences. For example, a company building a plant financed by a loan in Euro would capitalize all foreign exchange losses on the Euro loan as part of the cost of the building during construction of the plant. This is not permitted under IFRS (except in the limited circumstances foreseen under IAS 23, *Borrowing Costs*), which require that such foreign exchange differences be recognized in the income statement. In capital intensive industries borrowing in Euro this may result in materially overstated PPE.
- **Impairment of assets may not be timely recognized.** PARs require the use of the permanent diminution in value concept and provide no guidance on application. Practitioners assert that the use of permanent diminution in value is likely to result in a delay in recognizing impairment losses and hence overstated assets.
- **Agriculture.** PARs do not contain any provision similar to IAS 41, *Agriculture*. Based on the fragmented nature of Polish agriculture the lack of rules compliant with IAS 41 is unlikely to have a significant impact in the short-term (except for larger producers; e.g. poultry farms). However these differences may start to matter in the coming years with the expected restructuring and consolidation of the agriculture sector.

In addition, the lack of standardized guidance on application of Polish accounting requirements supplemented by IFRS, as evidenced by only two Polish Accounting standards, gives rise to divergences in practice.

56. **There are specific differences between IFRS and Polish accounting requirements pertaining to banks.** As discussed in paragraph 17 above, banks are required to prepare financial statements in compliance with the Accounting Act and the Regulations issued by the Minister of Finance. Selected differences between current accounting requirements and full IFRS include the following:

- **Interest expense and revenue recognition does not reflect the effective yield.** Since January 1, 2002, PARs require that certain financial assets and liabilities are valued on the basis of amortized cost using the effective interest rate. However, the Decree of the Minister of Finance dated December 2, 2003, amending the Decree on specific accounting rules for banks provides for an extension of the deadline until January 1, 2005. This may introduce a significant bias in the income statement of large borrowers and lenders, which acquire debt at a deep discount or premium.
- **Loan loss allowances.** PARs require that banks perform, at least quarterly, a review of loan exposures and classify them into risk categories, i.e. normal, watch, substandard, etc.). The classification is largely based on timeliness of repayments of

<sup>72</sup> PARs include a general requirement consistent with IFRS based on which some auditors—but not all—require that a provision be recognized.

loans and the economic and financial condition of the borrower. PARs require banks to calculate impairment in the unsecured portion of loans and receivables on the basis of a provisioning matrix that specifies a range of fixed minimum provisioning rates for each category (from 1.5% to 100%). In addition, the required specific provision for loan exposures relating to retail loans classified as (1) “normal” is decreased by 25% of the general banking risk provision or (2) “watch” is decreased by 25% of the general banking risk provision in accordance with article 130 of the Banking Act. However, this methodology may not comply with IAS 39, which requires impairment or loan losses to be calculated as the difference between the asset’s carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset’s original effective interest rate for fixed interest rate instruments.

57. **There are specific differences between Polish accounting requirements pertaining to insurance companies and IFRS.** As discussed in paragraph 18 above, insurance companies are required to prepare financial statements in compliance with the Accounting Act and the Regulations issued by the Minister of Finance. In addition to some of the differences highlighted in paragraph 56 above, selected differences between current accounting requirements and full IFRS include the following:

- **Expanded disclosures.** The expanded disclosure requirements should not be overlooked. For insurance contracts, the disclosure requirements are found in IFRS 4. IFRS 4 has two main disclosure requirements: **Principle 1: Explanation of reported amounts** – “an insurer shall disclose information that identifies and explains the amounts in its financial statements arising from insurance contracts”. **Principle 2: Amount, timing and uncertainty of cash flows** – “an insurer shall disclose information that helps users to understand the amount, timing and uncertainty of future cash flows from insurance contracts.” The disclosures required under PARs in some cases may be insufficiently broad and detailed enough to comply with IFRS requirements.

The disclosures likely to generate the greatest added effort or the greatest interest include:

- Risk management objectives and the policies established to mitigate insurance risk.
- Terms and conditions of insurance contracts that are likely to have a material impact on the amount, timing, and certainty of future cash flows.
- Information on interest risk and credit risk that is likely to be particularly important for reinsurance contracts.
- Insurance risk, including sensitivity analysis, and information about concentration of insurance risk (e.g., exposures on a group life portfolio).
- Details of actual claims development compared to previous estimates.

58. **The ROSC team made assessments of the compliance gap sampling seven sets of financial statements, which purport to be prepared in accordance with IFRS, and 15 sets that purport to be prepared in accordance with Polish accounting requirement.** For the sample review, the ROSC team selected 16 enterprise sector companies (listed and unlisted), two banks, two pension funds and two investment funds.<sup>73</sup> The quality of IFRS financial statements is

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<sup>73</sup> Thirteen entities in the sample are audited by local member firms of international audit firm networks. Nine entities are audited by local audit firms. Among the sample of seven IFRS-based financial

variable with some suggestions of non-compliance with IFRS in which auditors have issued unqualified opinions. The quality of Polish accounting requirements-based financial statements was generally weak with a number of significant issues.<sup>74</sup>

- ***Property, plant, and equipment (PPE) may be under or overstated.*** The IFRS consolidated financial statements of a listed company were not adjusted for the effects of inflation as required by IAS 29, Financial Reporting in Hyperinflationary Economies, in 1996 and 1997 when the Polish economy was hyperinflationary. The audit opinion is qualified with respect to this matter. Also, PPE was revalued up to and including January 1, 1995 using indices determined by the central statistical office for individual groups of fixed assets. Both the company, in its accounting policies, and the auditors state that this is a departure from IAS 29 which requires the application of a general price index. These departures from IFRS make it very difficult for a user to ascertain the value of PPE and compare the company's performance to its peers.
- ***Choice of the US\$ as a measurement currency allows the company to avoid reporting any losses or gains on its long-term debt.*** The IFRS financial statements of a large company are prepared using the US\$ as the measurement currency "since the company believes that it reflects in a more appropriate manner the Company events and transactions in the financial statements". The company owns commercial and office real estate in companies in Warsaw, is developing and leasing or selling space to commercial and individual tenants, and is constructing residential units in Poland. The company explains that the majority of revenue from operations is incurred predominantly on the basis of amounts denominated in, directly linked to or indexed by reference to the US\$. Furthermore virtually the whole of the company's long-term loans are designated in US\$ (some are designated in Euro). It is almost certain that the use of the US\$ as the measurement currency (functional currency) would not comply with the revised version of IAS 21, *The Effects of Changes in Foreign Exchange Rates*, approved in 2004 as Poland, and not the United States, is the primary economic environment in which the entity operates. SIC 19, *Reporting Currency – Measurement and Presentation of Financial Statements under IAS 21 and IAS 29* (which applies to the 2003 financial statements), requires that the measurement currency should provide information about the entity "that is useful and reflects the economic substance of the underlying events and circumstances relevant to the entity". Given that the company operates solely within Poland and that the success or failure of its property investments depends on the Polish economy, the use of the Polish currency would have been a much more appropriate choice of measurement currency. By using the US\$ the company avoids reporting any losses or gains on the long-term debt designated in US\$.
- ***Non-transparent financial reporting.*** The PAR-based financial statements of a non-listed economically significant enterprise departed significantly from PARs. The audit opinion is qualified with respect to some of these matters. For example, the

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statements, three audit reports were unqualified, three were qualified, and one was a disclaimer of opinion. Among the sample of fifteen Polish accounting requirements-based financial statements, thirteen audit reports were unqualified (two included an emphasis of a matter paragraph), and two were qualified.

<sup>74</sup> The ROSC team used stratified random sampling to select the companies that were analyzed in this report. However, due to the sample's small size, it cannot be considered to be representative of all listed companies. Hence, the findings, although useful for illustrating potential problems in financial reporting, pertain to shortcomings found in the financial statements of specific companies. The findings are not meant to reflect systemic problems that would apply to listed companies in general.

company did not seem to account for a PLN 30 million pipeline (equivalent to approximately EUR 7.3 million); recorded an increase in share capital by PLN 6.9 million (equivalent to approximately EUR 1.7 million) but did not disclose how the transaction was structured; received “donations” amounting to PLN 58 million (equivalent to approximately EUR 14.2 million) but did not disclose how these grants were recorded.

- **Provisions for employment benefits may be understated.** Two non-listed economically significant enterprises did not disclose in their PAR-based financial statements how they account for jubilees, retirement benefits, and vacation benefits. These may not have been recorded at all.
- **Potential overstatement of “perpetual usufruct”.** Three non-listed economically significant enterprises presented their PAR-based financial statements including revalued “perpetual usufruct” in the balance sheet and showing the unrealized revaluation gain as equity.<sup>75</sup> The unrealized revaluation gain was significant: In the first company it amounted to PLN 239 (equivalent to approximately EUR 58.5 million) and represented 90% of net equity; in the second company it amounted 228 million (equivalent to approximately EUR 55.9 million) and represented 40% of net equity; in the third company it represented 20% of net equity.
- **Use of boilerplate disclosures.** The PAR-based financial statements of two listed companies and three non-listed economically significant enterprises included boilerplate disclosures, which would not allow a user to make any informed decision based on the financial statements.

59. **The assessments revealed that financial statements are often influenced by taxation rules.** To satisfy requirements of taxation authorities with regard to recognition of revenues and expenses, preparers of general-purpose financial statements of small- and medium-size private companies and *public interest entities* tend to follow tax rules rather than the accounting treatment set required by Polish accounting requirements in various areas (e.g., depreciation, revenue recognition, provisions).<sup>76</sup> Transparency and accountability suffer from this emphasis on tax and deviation from applicable financial reporting standards.

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

60. **International Standards on Auditing (ISA) have not yet been adopted as mandatory in Poland.**

61. **Currently, when conducting an audit, the statutory auditor is obliged to adhere to Polish auditing standards set by KIBR.** The standards passed by KIBR, being based on ISA, represent a simplified version ISA and state that where an issue is not covered by the Polish standards, where doubt exists and where establishing the detailed methodology for conducting an audit then the auditor shall refer to ISA<sup>77</sup>. The 2001 version of ISA has been translated by the AAP with full permission from IFAC. A 2004 version has been translated and awaits formal release.

<sup>75</sup> In Poland, “perpetual usufruct” is described as long-term leasehold (typically 99 years) rights to land.

<sup>76</sup> Among the eighteen sampled financial statements the ROSC team reviewed (excluding two investment funds and two pension funds), six used tax depreciation rates in their general purpose financial statements.

<sup>77</sup> See Standard 1, Chapter1, clause 7.

62. **Polish auditing standards are effectively an abbreviated, incomplete version of ISA. Practicing auditors generally comply with the strict wording of written Polish Auditing Standards; however, these the Polish standards lack ISA-compatible requirements in certain areas, which may have an impact on audit quality.** The ROSC team identified the following differences between Polish Standards and ISA which may have an impact on audit quality:

- ***Polish Standards set few requirements for audit sampling and other selective testing.*** Unlike ISA 530, *Audit Sampling and Other Selective Testing Procedures*, Standard 1 treats sampling in a very terse way. There appears to be an underlying assumption that ISA 530 will be applied but the specific definitions and provisions of ISA 530 are excluded from the Polish standard. All audits are based on some form of selective testing and it is therefore important that selection procedures are designed in a way to ensure that audit objects are properly met. As Polish auditors are required to follow Polish auditing standards, there is a possibility that sampling and other selective testing procedures employed in Polish audits, whilst complying with the strict wording of Polish auditing standards, will nevertheless fall short of the appropriate confidence levels for making conclusions on the population as a whole. This may undermine public confidence in the audit function.
- ***There is no specific requirement for the auditor to make a final assessment of the reasonableness of an accounting estimate based on the auditor's knowledge of the business and whether the estimate is consistent with other audit evidence obtained during the audit as required by ISA 540, Audit of Accounting Estimates.*** Again there appears to be an underlying assumption that the ISA will be applied but no absolute requirement to do so. ISA 540 requires that the auditor consider whether there are any significant subsequent transactions or events which affect the data and the assumptions used in determining the accounting estimates.<sup>78</sup> Because of the uncertainties inherent in accounting estimates, evaluating differences can be more difficult than in other areas of the audit. When there is a difference between the auditor's estimate of the amount best supported by the available audit evidence and the estimated amount included in the financial statements, the auditor needs to determine whether such a difference requires adjustment. Additionally, ISA 540 states that auditor must also consider whether individual differences which have been accepted as reasonable are biased in one direction, so that, on a cumulative basis, they may have a material effect on the financial statements. In such circumstances, the auditor would evaluate the accounting estimates taken as a whole<sup>79</sup>. Lack of such audit procedures may result in the audit failing to identify material misstatements in the financial statements.
- ***Polish Standards are less detailed in the area of related parties than ISA 550, Related Parties.*** In particular, procedures for identifying related parties and related party transactions are not specifically included in Polish Auditing Standard No.1. ISA 550 requires the auditor to undertake a series of specific procedures in respect of the completeness of information regarding related parties. Two aspects of related parties transactions are critical to the audit: (1) disclosure of related party transactions as required by IAS 24, *Related Party Disclosures*; and (2) the possibility that the existence of related parties increases the risk of management fraud. There are many legitimate reasons for related party transactions but the risk for an auditor is that

<sup>78</sup> See ISA 540, *Audit of Accounting Estimates*, paragraph 25.

<sup>79</sup> See ISA 540, *Audit of Accounting Estimates*, paragraph 27.

management will conceal transactions between related parties causing disclosures to be misstated. The absence of these procedures from Polish Auditing Standard No.1 raises the possibility that an auditor may conduct an audit in strict compliance with Polish regulations but fail to adequately address the risk of material misstatement or fraud.

- ***In relation to subsequent events Polish Standards do not stipulate that the auditor should consider legal and related requirements in all jurisdictions in which securities are being offered as required by ISA 560, Subsequent Events.*** Under the requirements of ISA 560 the auditor may be required to carry out additional audit procedures to the date of the final offering document. These procedures would ordinarily include reviewing the offering document to assess whether the other information in the offering document is consistent with the financial information with which the auditor is associated. Failure to do this may result in material misstatements that would have been detected if such procedures been implemented continuing to be unidentified to members of the public relying on information contained in the offering document.
- ***Polish Standards do not require the auditor to be as proactive concerning the validity of the going concern concept as required by ISA 570, Going Concern.*** Auditors should take positive steps to investigate the client's post-balance sheet health before simply assuming that it is viable as an ongoing entity. The auditor should therefore assess and evaluate management's assessment of the entity's ability to continue as a going concern. Failure to do so may result, as international experience demonstrates, in firms failing shortly after the production of financial statements that gave no indication of this possibility. Polish standards do not require the auditor to evaluate management's assessment of the entity's ability to continue as a going concern nor, if management's assessment of the entity's ability to continue as a going concern covers less than twelve months from the balance sheet date, to ask management to extend its assessment period to twelve months from the balance sheet date. ISA 560 states that the auditor does not have a responsibility to design audit procedures other than inquiry of management to test for indications of events or conditions which cast significant doubt on the entity's ability to continue as a going concern beyond the period assessed by management.<sup>80</sup>
- ***Polish Standards are less detailed than ISA 600, Using the Work of Another Auditor.*** Specifically, they are silent on the matter of performing procedures to obtain sufficient and appropriate audit evidence that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. In addition, Polish standards do not require that the principal auditor express a qualified opinion or disclaimer of opinion because of a limitation in the scope of the audit when the work of the other auditor could not be used, and the principal auditor was not able to perform sufficient additional procedures regarding the component audited by the other auditor. This matter is most apparent with the audit of consolidated financial statements, where the audit of a subsidiary company's financial statements has been undertaken by a different auditor or audit firm. It is not that the standards of the subsidiary auditor are necessarily in question, but that information material to the consolidated financial statements should be available to

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<sup>80</sup> See ISA 570, *Going Concern*, paragraph 25.

the auditor of those consolidated financial statements. The use of inter-firm questionnaires and co-operation between auditors is required in this area.<sup>81</sup>

63. **There is conflicting evidence about the quality of statutory audits.** From the review of a sample of audited financial statements (see paragraph 58 above) and discussions conducted by the ROSC team with sole practitioners, small and large audit firms, and KIBR, specific issues surfaced that adversely impact the average quality of auditing practices in Poland:

- **Misleading auditor’s report.** There are examples of auditors using “emphasis of matter” paragraphs in place of qualified opinions. The Accounting Act requires that the audit opinion should unequivocally indicate the reasons for objections, negative opinion or refusal to grant an opinion owing to circumstances preventing its formulation. The objections must be presented in a manner indicating their scope and extent.<sup>82</sup> Emphasis of matter paragraphs should be used where an item is of particular importance to understanding the financial statements but where the matter does not affect the audit opinion in any way. It is common for these to be concerned with uncertainty. However, if the uncertainty is significant and material and not adequately disclosed the auditor should consider issuing a qualified audit opinion or a disclaimer of opinion. Overuse of the emphasis of matter paragraph leads to a “comply or explain” regime and it becomes less certain as to the precise nature of the auditor’s opinion, thus increasing the risk of misleading users of the financial statements. Selected examples noted by the ROSC team include:
  - **Revenue recognition falls short of IFRS requirements.** The audit report of a listed company includes an emphasis of a matter, which relates to the change in the recognition of revenue and costs for software production and implementation. In prior periods, revenue was recognized according to sales invoices issued because of the limitations of the company’s cost accounting system. In 2003, the company adopted the percentage of completion method. It accounted for the contracts during the year 2003 in accordance with the new policy but did not have the necessary information to make the change on a retrospective basis.<sup>83</sup> Irrespective of whether the new policy was applied retrospectively, the failure to use the percentage of completion method in prior periods did not comply with IFRS and should have lead to a qualified audit opinion. Furthermore, the 2003 emphasis of matter on the failure to restate comparative periods for the change in accounting policy is inappropriate. Either the auditors agree with the lack of a restatement for the prior periods (unqualified report) or disagree with the lack of restatement (qualified opinion for non-compliance with IAS 8, *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*—revised 1993).
  - **Goodwill may be overstated.** The audit report of a listed company includes and emphasis of a matter, which relates to the carrying amount of goodwill arising on an acquisition major in 2003. The auditors point out that the acquiree had net liabilities of approximately PLN 2 million (equivalent to approximately EUR 490,000) and that the “realizability” of goodwill

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<sup>81</sup> See IAS 600, *Using the Work of Another Auditor*, paragraphs 8 and 15.

<sup>82</sup> See Article 65.1 of the Accounting Act.

<sup>83</sup> In the opinion of management, the adjustment to the opening balances at as 1 January 2003 should not have a significant impact on the financial results in the 2003 financial statements though a reliable estimate of this amount is not possible.

depends on achieving the future results of operating activities of the acquired company. This statement is, of course, true of any goodwill and the purpose of the emphasis of matter is, therefore, unclear.

- ***Deferred tax assets may be overstated.*** The audit report of a listed company includes an emphasis of a matter, which relates to deferred tax assets in excess of PLN 14 million (equivalent to approximately EUR 3.4 million) arising on one of the subsidiaries. The auditors point out that this subsidiary incurred significant tax losses in 2002 and 2003 and add: “Realizability of the above mentioned asset depends on achievement of tax results by [subsidiary] forecasted for years 2004-2006.” Again, this statement is true of any deferred tax assets and the purpose of the emphasis of matter is unclear.
- ***Lack of documentation.*** The main deficiency highlighted by KIBR review of audit firms was a lack of fully documented audit testing. Some auditors do not document matters that are important in providing evidence to support their audit opinion and evidence that the audit was carried out in accordance with applicable standards. Lack of documentation means that a review of the audit is impossible. This holds true for internal review, as required by ISA 220, *Quality Control for Audit Work*<sup>84</sup>, or external review such as quality assurance visits. This in turn increases the risk of forming inappropriate audit opinions which may undermine public confidence in the audit process.
- ***Fraud and error.*** Responding to recent international corporate reporting scandals, the international standard on fraud and error has been reinforced by a recent amendment, which has not yet been reflected in Poland auditing practice. Auditors should document fraud risk factors identified as being present and document the auditor’s response to any such factors. But the main focus of the audit may not be concentrated on contemplating authentication of documentation. More worrisome is that few auditors appear to understand their responsibility to consider fraud in audits of financial statements, it being expressed to the ROSC team, by a senior member of the profession, that the auditor is “an adviser not an inspector.”

## V. PERCEPTIONS ON THE QUALITY OF FINANCIAL REPORTING

64. **The investor community has mixed perception on the quality of financial reporting.** It is clear that banks and other lending institutions do not use the financial statements of borrowers as the primary source of information for credit risk assessment when making loan decisions. However a qualified audit opinion will have some impact on the credit risk assessment as it is the only source of verification of the assets of a company. There remains a marked contrast between the financial information of listed and non-listed companies. Confidence in financial statements appears highest in regulated industries, particularly banks, where a qualified audit opinion will trigger an investigation.

65. **Observers commented that the quality of audit reports has improved dramatically in recent years.** Audit reports were in the past used to highlight many basic errors thus detracting from the overview. There is a generally held view that audit reports are now much more reliable than in the past. However, some observers commented that that there was considerable variability

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<sup>84</sup> See ISA 220, *Quality Control for Audit Work*, paragraph 15, which states that the work performed by each assistant needs to be reviewed by personnel of at least equal competence.

and lack of consistency in audit reports from audit firms. Public availability of practice review results and attendant enforcement actions would have the effect of creating a culture of compliance and thereby improve the perception of the audit profession as a whole.

66. **Representatives of the audit profession expressed the view that auditing was not highly valued.** They perceived there was no pressure from the market to improve quality of audit and improvement would not occur until the market valued the audit function more highly. It was felt that this was part of the development of the Polish economy. Some 70% of the GDP is generated by SMEs and these tend to raise capital by borrowing secured by assets rather than on the strength of the financial statements. This point of view was consistent with the views expressed by bankers.

## VI. POLICY RECOMMENDATIONS

67. **The recommendations of this ROSC accounting and auditing report are mutually supportive in some obvious ways.** For example, superb accounting standards are jeopardized at the beginning if people do not understand how to translate the standards into a journal entry. Without attempting to provide a detailed tactical design for reform, and without pretending to do justice to the true specificity of the country's conditions, this ROSC accounting and auditing report sketches the policy recommendations to enhance the quality of corporate financial reporting. As work on the economics of information—the role of information in a well-functioning economy—demonstrates, enhancing the reliability and availability of financial reporting is conducive to:

- Strengthening Poland's financial architecture and reducing the risk of financial market crises and their associated negative economic impacts, including through increased transparency about the financial condition and performance of *public interest entities*;
- Contributing to foreign direct and portfolio investment;
- Helping mobilize domestic savings;
- Facilitating investment decision-making by private pension fund managers;
- Facilitating the access of smaller-scale corporate borrowers, including small and medium enterprises, to credit from the formal financial sector by shifting gradually from collateral-based lending decisions to lending decisions which are based on the financial performance of the prospective borrower;
- Improving the assessment and collection of taxes on corporate profits;
- Allowing investors to evaluate corporate prospects and make informed investment and voting decisions, which will result in a lower cost of capital and a better allocation of resources; and
- Allowing shareholders and the public at large to assess management performance, thus influencing its behavior (financial reporting is also a building block of a market-based monitoring of companies); and
- Assisting the authorities to monitor and enforce compliance with the relevant portions of the *acquis communautaire*.

68. **Further enhancements to the statutory framework are needed.**<sup>85</sup> In this context, the authorities may want to create a multi-disciplinary working group, including all relevant public and private sector stakeholders, to review the statutory framework with a view to assess the effects of the forthcoming *acquis communautaire* in light of Poland's recent experience as a new EU Member State in implementing the *acquis communautaire*. Due consideration should be given to the forthcoming amendments to the Fourth and Seventh EU Company Law Directives, the Eighth EU Company Law Directive, as well as to the recently-enacted Transparency Directive. Some issues on which the working group may want to focus include:

- ***Take more advantage of the simplified financial reporting framework permitted by the Directives for SMEs.*** As noted in paragraph 14 above, among Poland's 106,700 limited liability and joint stock companies, only approximately 14,600 are allowed to apply simplified financial reporting requirements. As its economy grows, Poland could gradually increase the thresholds, as permitted by the Directives and in line with the practice in comparable EU Member States, to increase the number of entities subject to simplified financial reporting requirements.
- ***Ensure all public interest entities are required to present their consolidated financial statements in accordance with (endorsed) IFRS.*** In order to better meet the expectations and needs of users of financial statements prepared by *public interest entities*, *public interest entities* should be required to prepare their consolidated financial statements in conformity with IFRS. Clearly, this measure would go a step ahead of the current requirements of the *acquis*, as this is not yet required by the EU—other than for the consolidated financial statements of listed companies—however, the ROSC team believes that it would be valuable for enhancing the transparency of financial reporting of *public interest entities*. Also, this would be a solution to the existing shortcomings in Polish accounting requirements noted in paragraphs 15 and 55 above.
- ***Conflicting or ambiguous financial reporting requirements.*** The working group should review the Polish legal framework to ensure that there are no conflicting or ambiguous financial reporting requirements (see paragraphs 17 and 18 above). In this context, the working group should ensure that regulatory requirements do not affect IFRS-based general-purpose financial statements. Where the regulators need additional (unpublished) information for prudential supervision purposes, this should come by topping up IFRS. However, since the regulators would have a keen interest in ensuring that the fundamental IFRS-based general-purpose financial statements are correct (since their reports would be built on that foundation), this would mobilize them to assist in the enforcement of shareholder or stakeholder-oriented financial statements as well. This report analyses this issue regarding the banking sector in paragraphs 17 and 56 above. It analyses this issue in the insurance sector in paragraphs 18 and 57 above.
- ***Appointment and dismissal of statutory auditors.*** The working group should ensure that the legal provisions regarding the dismissal and resignation of statutory auditors provide adequate safeguards for his or her independence (see paragraph 21 above). The law could introduce the principle that the statutory auditor or audit firm can only be dismissed if there are proper grounds, and audited entity and auditor must inform the relevant authority about the dismissal or resignation during the term of appointment and explain why. These amendments should conform to the Eight EU

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<sup>85</sup> In Poland, accounting and auditing are primarily regulated by the Commercial Code, the Accounting Act, the Banking Act, the Insurance Act, the Auditing Act, the Securities Act, and related secondary legislation.

Company Law Directive's requirements, once approved by the European Parliament and Council.

- ***Use of the work of statutory auditors by regulators.*** The working group should ensure that the laws provide the Banking Supervision Commission, the Insurance and Pension Funds Supervisory Commission, and the KPWIG with a sound framework to fully leverage the work of statutory auditors. While present laws do give regulators relevant authority with respect to banks and insurance companies, the KPWIG appears to have less authority regarding the statutory auditors of listed companies (see paragraph 22 above). Also, requirements such as auditor rotation, auditor appointment, resignation, and dismissal should be harmonized or, in certain instances, clarified. The working group may want to propose amendments to existing laws so that the Insurance and Pension Funds Supervisory Commission, Banking Supervision Commission and KPWIG are given the authority to veto the appointment of a statutory auditor in insurance companies, banks and listed companies, respectively. Additionally, the Banking Supervision Commission and the KPWIG should be informed in advance of the proposed appointment of auditors of banks and listed companies, respectively, and have power to enquire about the capacity of the auditor that will carry out the engagement to ensure the auditor meets established standards of practice (e.g., technical competence, independence from the client, etc.).
- ***Adoption of the forthcoming Eighth EU Company Law Directive.*** The working group should assess the effects of the forthcoming Eight EU Company Law Directive and the sweeping changes that it will introduce in the regulation of statutory audits (see paragraph 70 below for a more comprehensive analysis).
- ***Readily and publicly available audited financial statements of limited liability companies.*** The working group should ensure that all accounting documents are made available in accordance with the forthcoming requirements of the First EU Company Law Directive (see paragraph 24 above). The *acquis communautaire* (through the July 15, 2003, amendment to the First EU Company Law Directive) only recently introduced a requirement that, no later than January 1, 2007, audited legal entity and consolidated financial statements, starting 1997, be obtainable from the court register by paper means or by electronic means as the applicant chooses. This should not be viewed as simply a formal requirement; but rather an opportunity for factoring companies, credit insurance companies, commercial banks, and the corporate sector in general when assessing and managing credit risk. In addition, deterrent incentives should be sufficient to ensure that companies actually comply with filing requirements (refer to paragraph 24 above).
- ***Readily and publicly available audited financial statements of listed companies.*** The working group should ensure the Polish legislation is aligned with the requirements of the Transparency Directive (see paragraphs 25 above). The Transparency Directive, which should be transposed by Member States no later than January 20, 2007, requires listed companies to prepare and present annual financial reports and half-yearly financial reports, including consolidated financial statements, within four months of the year and two months of the end of the semester, respectively.

69. **Polish institutions should have resources to actively and systematically participate in the European policy-making process, through an active role in relevant EU Committees (see paragraph 8 above).** This is important not only to keep abreast with the ongoing changes to the *acquis communautaire*. It will also allow Poland to both promote policies that are in the national interest, as well as act to prevent decisions that could cause difficulties in regard to practical

implementation at the national level. This necessarily involves effective participation by Polish institutions in relevant EU advisory committees, including CESR-fin Sub-Committee on Enforcement, CESR-fin Sub-Committee on International Standards Endorsement, CESR-fin Audit Task Force, the Committee of European Insurance and Occupational Pensions Supervisors; the Committee of European Banking Supervisors, the Contact Committee, the Committee on Auditing (or its successor) and the European Enforcers Coordination Sessions (EECS). In addition, relevant Polish ministries should have the resources to actively participate in those committees that assist the European Commission in its decision making, including the European Securities Committee, the European Insurance and Occupational Pensions Committee, the European Banking Committee, the Accounting Regulatory Committee, and the soon-to-be-established Audit Regulatory Committee.

70. **Enhance statutory audit quality and public trust in the audit profession.** The following major issues should be addressed in order to effectively rectify the problems set forth in Section I.B and I.C. While the transposition of the Eight EU Company Law Directive's requirements, once approved by the European Parliament and Council, should establish a sound framework for enhanced statutory audit quality, this report highlights areas of immediate concerns:

- ***A Public Overview Body for KIBR should be established.*** The existing quality assurance systems should have adequate public oversight consisting of a majority of non-practitioners on the overview body of the quality assurance system. The purpose of the overview body is to ensure that quality assurance is, in fact and appearance, an exercise with sufficient public integrity and meets the objective of sustaining public confidence and demonstrating to regulators the adequate discharge of self-regulating responsibilities.

As noted in paragraph 28 above, institutional investors, commercial banks, and other users of audited financial statements pointed to an uneven profession, where a number of statutory auditors who were grandfathered into the profession in 1994 may not have been subject to the same professional qualification requirements as the more recently certified auditors. The public oversight system should ensure that all auditors are subject to a quality assurance review and related disciplinary sanctions, which does not compromise on audit quality.

- ***Ensure that KIBR formally endorse and follow its mandate to serve the public interest (see paragraph 29 above).***
- ***Assess whether the minimum level of professional indemnity insurance (refer to paragraph 32 above) should be increased or determined by reference to the auditor's portfolio of statutory and contractual audits.***
- ***Greater transparency should be introduced to KIBR's quality assurance and disciplinary procedures.*** Quality assurance is the profession's principal means of assuring the public and regulators that auditors and audit firms are performing at a level that meets the established auditing standards and ethical rules. It is necessary to have a systematic link between negative outcomes of quality reviews and initiating sanctions under the disciplinary system. As a minimum:
  - An annual quality assurance report, giving a summary of quality assurance activities and statistical information regarding the outcomes of visits, should be published.
  - Decisions taken by the Disciplinary Spokesman regarding referrals to the National Disciplinary Court should be justified and subject to review by a public oversight body.

- The proceedings and decisions of the National Disciplinary Court should be published and remain in the public domain.

In addition, the uncertainty regarding confidentially arrangements, noted in paragraph 54 above, should be clarified so that inspectors have the right to require the production of audit work papers, and any other document or information in the possession of the audit firm, or any associated person thereof.

- ***Poland should adopt both ISA and the IFAC Code of Ethics in their entirety.*** Currently, Polish auditing standards and the existing Code of Ethics are effectively abbreviated versions of ISA and the IFAC Code of Ethics. This results in the possibility of auditing falling short of internationally acceptable standards whilst still complying with Polish requirements (see paragraph 62 above). The adoption of ISA and the IFAC Code of Ethics should be consistent with the requirements of the new Eighth EU Company Law Directive as well as with IFAC’s Statements of Membership Obligation No. 4, *IFAC Code of Ethics for Professional Accountants*.
- ***The Capacity of KIBR should be increased so as to enable it to make a more effective contribution to the Polish auditing profession.*** There should be a detailed review of the required activities of KIBR and a twinning arrangement with a respected European professional body should be considered. Among others, KIBR should introduce:
  - a technical advice help desk service for members;
  - an audit manual for small audit firms; and
  - a standard audit methodology and audit program pack for small audit firms.

In order to do this it will require the employment of full time professionally qualified technical staff by KIBR who will ensure that the full requirements of ISA are incorporated into the standard materials.

- ***Ensure greater transparency on the relationship between local firms and their network, according to the forthcoming requirements under the proposal for a new Eight EU Company Law Directive.*** As a condition of using an international network name, require the local member firms of international audit firm networks to disclose sufficient information about the structure and operation of their respective networks and about their individual relationships with them. The disclosure would enable an audit report user to assess the extent of reliance that can be placed on the implicit quality assertion that underlies the use of a common international network brand name. Such disclosures should describe the quality standards applied by the networks, the quality assurance for enforcement of standards, and details of how frequently the local firm is subject to network review. This would force the networks to exercise a much higher standard of care with respect to the quality of their member firms—since their procedures would be publicly transparent—and would ensure that quality weaknesses are addressed rapidly.

**71. The ASC should include enough persons with extensive experience in preparing and analyzing financial statements in order to reflect the broad range of interests affected and understand the practical implications of the ASC’s decisions.**

**72. Poland should strengthen the institutionalized incentives for the rigorous application of high quality financial reporting requirements in the corporate—financial and non-financial—sector.** Prior to EU accession the stakeholders have focused on aligning the regulatory framework with the requirements of the *acquis*. In this early stage after accession, the authorities and relevant stakeholders should seek to put in place proper incentives to ensure that

the *acquis* is actually applied in practice. Market forces provide certain positive incentives to comply with high standards, but experience suggests that countervailing disincentives operate to discourage such compliance. Drawing on recent post-scandal reforms in several OECD countries, more emphasis should be placed on the deterrent incentives of robust enforcement regimes, and the following recommendations promote a full and balanced combination of capacity and incentives (both positive and deterrent) to increase actual implementation of the *acquis*:

The key following recommendations are drafted to build on the positive steps that have been undertaken to implement measures to comply with the CESR principles but at a level that is more likely to meet the challenges of an expanding market, which anticipates 50 Initial Public Offerings (IPOs) in the next year. They offer both short term actions (targeted and focused reviews) and longer term proposals that would need additional funding commitment.

Scarcity of appropriate and informed resource is a clear and immediate problem but one that may not be able to be addressed in the short term. While encouraging the development of a dedicated and experienced enforcement resource, the recommendations seek, as a priority, to address how SEC might make more effective use of the little resource it has by:

- targeting and focusing its monitoring activities with a view to achieving measurable targets in a short time-frame;
- encouraging a culture of compliance – on the part of preparers and users; and
- increasing its deterrent effect through example and education – thereby reducing the need, over the longer term, for regulatory intervention and having an impact on cost.

73. **KPWIG should develop a unit dedicated to, and with clear responsibility for, the monitoring of financial information staffed by appropriately experienced and senior personnel.** Given the number of issuers, the unit should comprise an adequate number of staff with clear public responsibility for the monitoring function. The unit should not be available for other functions of the wider department—except for consultation and analysis on technical issues—and should develop a public profile that is distinct from other functions of KPWIG. A secondment to a regulatory body of another Member State might be considered as a practical means of demonstrating how a unit might be developed.<sup>86</sup>

74. **The unit should consider and develop a targeted approach to the monitoring of financial information consistent with the risk-based approach identified in the CESR Standards of Enforcement.** The unit should develop a targeted approach to the monitoring of financial information that focuses attention, effort and costs to specific areas of financial reporting where results could be more readily demonstrated, and where they would have an impact on the market and the expectations of users. Initially however, focus could be concentrated on a program that takes account of:

- **Market:** For example, an analysis of listed issuers may show that a substantial percentage of the total market capitalization is represented by a small number of very large companies. Dedicated effort on the financial statements of such companies might give a high degree of coverage of the market with little, but focused, intensive investigative effort. Although the probability of error might be lower, the impact of any accounting breach would be significant.
- **Industry:** A second key to selection might be industry focus – this would allow the monitoring function to address and focus on key industry issues arising from application of IFRS. Construction might be an example where issuers have

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<sup>86</sup> The scarce resources reported in other Member States and the pressures under which they are operating might reduce this potential as would language difficulties.

recognized the challenges of reporting under the new framework and have proactively sought assistance and training in how to apply the new requirements. Initially, industry focus might be better applied to a precise sector where there are only one or two large listed entities. These reviews could be supported by reviews of a restricted number of smaller companies to reflect the depth of the industry.

- **Size:** Selection of specific companies for review might fall out naturally from this approach. Specific trigger factors could, however, be applied at this level. Initially these may need to be fairly broad-brush, but could include quality of corporate governance, and unusual and complex transactions, with poor performance prompting more aggressive policies. This information can be time-consuming to access, record and compare, and may not be appropriate in the short term.
- **Qualified audit reports:** Given the anecdotal evidence relating to the frequency of qualified audit reports, the unit might select specific companies where, *prima facie*, the financial statements do not appear to have been presented in accordance with IFRS – for instance, an audit report qualified for disagreement.

75. **The result of any such enquiry if pursued to enforcement action, and if publicly reported with a statement of the unit’s rationale, would send a clear message to all preparers and investors who have, in the past, accepted that disclosure within a qualified audit report is adequate.** Investors would be encouraged to expect compliance and to see evidence of enforcement action where there is none; companies would appreciate that compliance is mandatory not optional, and auditors would be given the support they need to persuade preparers of the need to comply. A targeted program of this nature could be put in place with almost immediate effect. A second type of targeted approach might be a restricted review of a sample of company financial statements for compliance with a specific accounting disclosure. SEC is currently reviewing 90 sets of financial statements for compliance with the requirement to explain the anticipated accounting changes expected as a result of IFRS. This is a large sample out a population of some 230 – and would require considerable resources to follow up. It could be suggested that equally representative results could be obtained from a review of a much smaller sample if targeted on the principles set out above.

76. **The unit should develop a sophisticated review of financial information consistent with the principles based approach of IFRS.** No evidence was provided to demonstrate the depth of any review of accounting information. A checklist approach is applied replicating the disclosure requirements of the Act. The unit could assess and review the methodologies and checklists applied by auditors when assessing compliance with IFRS and go beyond mere disclosure compliance. The unit could also seek further training from the accounting firms on the practice of analytical review and more sophisticated review techniques using ratio analysis.

77. **The unit should use the gateways that have been put in place through recent legislation and side agreements to share information with other regulators to work together to effect an improvement in the presentation of financial information.** Other regulators may also be prepared to provide information feeds to the unit’s risk assessment arising out of their reviews of regulatory returns – for example, where a bank’s capital falls below the regulatory capital mark.

78. **The unit should consider whether it has a full complement of enforcement actions appropriate to its function.** KPWIG should have the power to require a corrective announcement and to effect a revision of defective financial statements, which would be required

to be reported to the Registrar. While this is not a CESR requirement (it is not available in all jurisdictions), it can be an effective deterrent action.

79. **The unit should continue to use the contact it has with the Listed Issuers Association as a means of informing and educating companies of KPWIG's monitoring approach, the manner in which it is to conduct its enquiries, the powers that it has and the obligations under which companies now report.** KPWIG appears to have a good working relationship with this Association which is well supported by issuers and proactive in approach. It provides a ready-made conduit for possible dissemination of any changes in the monitoring or enforcement function of KPWIG.

80. **The KIBR syllabus should be updated and modernized.** The syllabus should be reviewed and updated so as to be fully IFAC and IFRS compliant. Clearly, the instances where Polish Accounting Requirements differ from IFRS need to be retained in the syllabus, but the main thrust of the syllabus content should be directed at the provisions of IFRS as this is the basis of the Polish financial reporting system generally and specifically for the public interest entities.

81. **IFRS should be introduced into accountancy education at university level.** Currently, most accountancy education at university level is based on Polish Accounting Requirements, although, as noted in this report, some movement towards IFRS has been made at the WSE. These developments should be replicated in other universities and colleges so as to facilitate the supply of IFRS conversant accountants in the future.

82. **Accounting education should be rationalized so as to develop a continuum from university education through to professional qualification.** Given the clear policy of Poland to move closer towards IFRS and ISA based accounting and auditing, it is important that these principles are incorporated into every level of accounting education and that the education continuum becomes increasingly integrated with subsequent level building upon previous levels. In this way, the underlying principles of IFRS and ISA will become established as the norm within the Polish accounting and auditing profession, and accounting reform will become increasingly more effective.