

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

ACCOUNTING AND AUDITING

October 11, 2004

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Executive Summary

This report provides an assessment of accounting, financial reporting, and auditing requirements and practices within the enterprise and financial sectors in Slovenia, using International Financial Reporting Standards (IFRSs); International Standards on Auditing (ISAs); and the relevant portions of European Union (EU) law (also known as the *acquis communautaire*, as benchmarks. It draws on international experience and good practices in the field of accounting and audit regulation.

In the area of financial reporting and auditing law, Slovenia implemented the Fourth, Seventh, and Eighth EU Company Law Directives, and ISAs. The Company Act requires that all companies, including banks, insurance companies, and listed companies, prepare legal and consolidated financial statements in conformity with Slovenian Accounting Standards. These national standards generally meet the identified needs of users of small- and medium-sized enterprises' financial statements. However, in order to better meet the expectations and needs of users—especially foreign users—of financial statements prepared by *public interest entities* (e.g., banks, insurance companies, listed companies), this report recommends that they adopt IFRSs. Clearly, this measure would go a step ahead of the current requirements of the *acquis*, as this is not yet required by the EU; however, the ROSC team believes that it would be valuable for enhancing the transparency of financial reporting of PIEs.

Slovenian 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. However, this report strongly recommends that existing arrangements be reassessed in the wake of international corporate accounting scandals and the proposal for a new Eighth EU Company Law Directive, which will require enhanced public oversight of the auditing profession.

As new regulations come into force, priorities are now turning to build 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 Slovenia has to tackle. This report draws upon recent international experience in developed economies and accession countries, as well as expected amendments to the *acquis communautaire* and recommends that Slovenia strengthen the enforcement of accounting and auditing standards.

This report was prepared by a team from the World Bank on the basis of the findings from a diagnostic review carried out in Slovenia in November 2003. The staff team was led by Frédéric Gielen (ECSPS). The review was conducted through a participatory process involving various stakeholders and led by the country authorities.

I. INTRODUCTION

1. This assessment of accounting and auditing practices in Slovenia 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). 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 (IFRSs),¹ International Standards on Auditing (ISAs), and the relevant portions of European Union (EU) law (also known as the *acquis communautaire*) as benchmarks and draws on international experience and good practices in the field of accounting and audit regulation.

2. Slovenia has a population of 1.96 million and a Gross Domestic Product (GDP) per capita of US\$14,000 for 2003 and of US\$19,000 based on purchasing-power-parity (PPP). Slovenia's achievements over the past several years have been remarkable. Thirteen years after independence from the former Socialist Federative Republic of Yugoslavia, the country is among the most advanced of all the transition economies in Central and Eastern Europe. Slovenia's aspirations to modernize its economy and join the European Union (EU) have been the driving force for economic reforms. The authorities have completed negotiations for EU membership and Slovenia joined the EU on May 1, 2004.

3. Slovenia has adopted a gradualist approach to economic reform. The first stage of privatization in Slovenia of socially owned enterprises began in 1992, using different measures, including management and employee buyouts, voucher privatization via investment funds, and direct sales. By the end of 1998, the privatization of some 1,600 socially owned enterprises was complete. However, the process resulted in a dispersion of ownership among various state institutions, investment funds (which have remained passive owners), and, most notably, managers and employees.

4. The banking system is relatively well developed by central European standards. The system is sound and well capitalized, with a low proportion of nonperforming loans. A French bank acquired, in 2001, a majority controlling share in the fourth largest bank (and largest private bank) in Slovenia. Also, the Government organized the sale of a one-third stake in the largest bank, which holds roughly 35 percent of the Slovenian banking market, to a Belgian bank. With these interventions, at the end of 2003, the central government's share in the banking system amounted to 19.6 percent, that of foreign equity amounted to 33.7 percent and that of other domestic persons amounted to 46.7 percent. In 2003 some 20 banks and two savings institutions were operating in Slovenia.

5. Although the Ljubljana Stock Exchange was established in December 1989, it has failed to challenge the banks as a source of funding for the corporate sector or a destination for the population's savings. However, a broad range of Slovenian enterprises became listed toward the end of the 1990s. These new listings resulted primarily from the privatization process (i.e., a

¹ International Accounting Standards (IASs) and Interpretations of the Standing Interpretations Committee (SICs) were adopted by the International Accounting Standards Board (IASB) in April 2001. At this time, the IASB endorsed all IASs issued by its predecessor, the International Accounting Standards Committee (IASC). The accounting standards that the IASB develops are called International Financial Reporting Standards (IFRSs) and the interpretations of IFRSs are published as interpretations of the International Financial Reporting Interpretations Committee (IFRICs). For the purpose of this report, those standards and interpretations are referred to as IFRSs.

change in ownership, with no new capital raised), rather than real initial public offerings (i.e., with fresh capital being contributed). Also, the pension system reform, with the introduction of private investment to supplement the mandatory state insurance, should give a boost to the stock market. With real deposit rates close to zero and falling steadily in 2003, investors seeking alternative uses for their wealth turned to the stock market. Liquidity also flowed into the capital markets from Slovenia's growing mutual fund industry. In 2003, payments into Slovenian mutual funds reached Slovenia Tolars (SIT) 26.1 billion (equivalent to approximately US\$140 million).² As of December 31, 2003, there were 134 listed companies with a market capitalization of US\$7.1 billion, which represents approximately 25 percent of 2003 GDP. The figure does not include 26 closed-end funds also admitted to the organized market with a market cap of US\$1.2 billion. The market value of publicly-traded bonds as of the December 31, 2003, amounted to US\$4.6 billion.

6. The insurance industry is developing. The state retains an 85 percent stake in the market leader. Insurance penetration, expressed in terms of premium as a percentage of GDP (5.3 percent including health), is the highest among the transitional Central European countries.

7. In joining the EU, the Slovenian Government and market institutions have had to introduce and implement the *acquis communautaire* for corporate financial reporting within their respective regulatory domains. Necessary though headline regulations may be, a clear lesson from recent corporate scandals is that they need to be effectively enforced and supplemented by the use of incentives and information to maximize the number of well-informed, well-motivated stakeholders. Effective functioning of banking and capital markets requires a supporting infrastructure for financial information disclosure.

II. INSTITUTIONAL FRAMEWORK

A. Statutory Framework

8. **In law, Slovenia 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 EU Member States and other first wave accession countries—Slovenia has to address significant issues in the design and strengthening of suitable institutions to implement and enforce the *acquis* requirements. In addition, policymakers have to keep abreast with ongoing changes to the *acquis*, which are part of the international response to recent corporate accounting scandals.

9. **Business activities in Slovenia are primarily regulated by the Company Act (amended 2001), which is based on the *acquis communautaire* and the German legal tradition.** The most widely used and modern company structures are the limited liability company (*d.o.o.*) and joint stock company (*d.d.*). Most Slovenian companies select the limited liability company structure. Only a joint stock company may issue shares, and thus be listed on the stock exchange. Large or listed joint stock companies have a two-tier management structure (supervisory board and management board) and most limited liability companies, a single-tier management structure (management board).

10. **The Company Act establishes that members of the management board, not the supervisory board, are collectively responsible for the probity of financial statements.** Under the Company Act, management board members are “jointly and severally liable to the company

² Value based on the rate applicable at December 31, 2003 (SIT 187=US\$1).

for damage arising as a consequence of a violation of their duties, unless they demonstrate that they fulfilled their duties honestly and conscientiously.” Slovenian lawyers contend that this provision would be interpreted by a court as a collective responsibility of the members of the management board for the probity of financial statements. In a two-tier structure, supervisory directors do not appear to be responsible for the probity of financial statements.³ This may not be an appropriate mechanism to mitigate the risk that a limited number of management board members, in particular certain executive directors whose performance is to be reflected in financial statements, have a decisive role in determining the content of financial statements. The Criminal Code also provides that intentional presentation and submission of false financial statements is a criminal offense. However, in practice the legacy of the Yugoslav accounting system, in which the chief accountant was responsible for the probity of financial statements, can still have an adverse impact: Directors, lacking attention to the task, may not always review the financial statements or the critical accounting policies and practices applied by the company.

11. **In practice, shareholders and supervisory directors do not always receive and approve consolidated financial statements.** Under the Company Act, the management board is required to present to the shareholders the annual report, including consolidated financial statements, and a report from the supervisory board stating the board’s opinion on the annual report. Listed companies and auditors indicated that practice lagged behind statutory requirements. This significantly impedes shareholders and supervisory directors from assessing the financial position and performance of major holding companies in particular.

12. **The Company Act requires all companies to apply Slovenian Accounting Standards (SASs) in their consolidated and legal entity financial statements.** The Slovenian Institute of Auditors adopted new Slovenian Accounting Standards in late 2001, which became effective for accounting periods beginning on or after January 1, 2002. As shown in Section III, Slovenian Accounting Standards differ in form from International Financial Reporting Standards since they are meant to be “an original merger of the national accounting theory and international requirements, specifically those defined by IFRSs and the relevant guidelines of the EU.”⁴ However, in substance they largely conform to IAS, as they existed in 2001. Taking advantage of the flexibility of the Fourth and Seventh EU Company Law Directives, Slovenia imposes simplified reporting requirements on small enterprises and sole proprietorships, which generally meet the identified needs of users of those entities’ financial statements.

13. **The law does not require public interest entities to prepare their consolidated and legal entity financial statements in conformity with IFRSs.**⁵ Credit institutions, insurance companies, and companies whose shares or other securities are quoted on the Ljubljana Stock Exchange are required to apply Slovenian Accounting Standards in their consolidated and legal entity financial statements. From 2005, EU Regulation 1606/2002 on the use of IFRSs requires

³ This is reflected in reports from supervisory boards by caveats such as “the Supervisory Board of [company’s name] has reviewed *the formal aspect* [emphasis added] concerning the 2002 annual report of the Board of Management.”

⁴ “Preface to the New Slovenian Accounting Standard,” by Marjan Odar, Ph.D., Director, Slovenian Institute of Auditors, Ljubljana, January 2002.

⁵ Within this report, *public interest entities* mean enterprises 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 of *public interest entities* include banks, insurance companies, investment funds, pension funds, listed companies, and large enterprises. This definition is consistent with the concept discussed and developed during the preparation of the Recommendations on quality assurance and auditor independence in the EU Committee on Auditing. The proposal for a new Eighth EU Company Law Directive includes further guidance on this matter.

that listed companies prepare their consolidated financial statements in accordance with “endorsed” International Financial Reporting Standards (i.e., IFRSs adopted by the European Commission). The general public may have an interest in Slovenia extending the requirement to prepare IFRS-based financial statements to other *public interest entities* since Slovenian Accounting Standards may not provide the general public with sufficient information about these enterprises.

14. **The Company Act requires that Slovenian *public interest entities* be audited.** While the Company Act does not use the term *public interest entity*, it mandates a statutory audit only in large- and medium-sized joint-stock companies, large limited companies, and listed enterprises.⁶ Banks and insurance companies fall under the definition of large companies irrespective of their actual size. Such a scope effectively covers all *public interest entities* and hence takes advantage of the exemption allowed under the Fourth and Seventh EU Company Law Directives in order not to impose an excessive audit burden on small- and medium-sized enterprises. The Auditing Act does not allow sole practitioners to carry out statutory audits of large or listed joint stock companies, banks, insurance companies, investment firms, and group audits.

15. **Effective from 2001, the Auditing Act requires that all statutory audits be carried out in accordance with International Standards on Auditing.** This requirement supports a uniformly high level of statutory audit quality in Slovenia. In principle, the requirement is consistent with the proposal by the European Commission to require the use of “endorsed” International Standards on Auditing (i.e., ISAs adopted by the European Commission) as a requirement for all EU statutory audits beginning 2006 onwards.

16. **Shareholders appoint the statutory auditor, but unlike in certain EU Member States, the Company 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. Also, the Act does not require statutory auditors to attend the annual shareholders’ meeting and be available for questions by the shareholders.

17. **There are additional legal requirements concerning audit of investment firms, banks, and insurance and listed companies.** The following factors apply in relation to statutory auditors of the licensees of the Bank of Slovenia, the Insurance Supervision Agency, and the Securities Market Agency:

- **Reporting requirements for investment firms.** Investment firms must comply with reporting requirements similar to those of public/listed companies (see paragraph 18). Investment firms must comply with the relevant provisions of the Securities Market Act, Decision on the Minimum Scope and Content of an Audit Inspection of Investment Firm, Decision on Detailed Content of the Business Report of Investment Firm, and Decision on Detailed Content of the Summary of an Audited Annual Report of Investment Firm. The Agency may not veto decisions regarding statutory auditors; however, if the Agency has questions on auditing, it may request additional information from the investment firm. There are also additional duties that auditors must carry out while auditing investment firms, which are based on “auditing

⁶ The Company Act defines medium-sized enterprises as entities that exceed two of three thresholds—balance sheet total SIT 500 million (equivalent to US\$2,700,000), net turnover SIT 1 billion (equivalent to US\$5,350,000), and number of employees (50); and large enterprises as entities that exceed two of three thresholds—balance sheet total SIT 2 billion (equivalent to US\$10,700,000), net turnover SIT 4 billion (equivalent to US\$21,400,000), and number of employees (250). These thresholds are in line with those in the Fourth EU Company Law Directive.

questionnaires and tables.” These are defined each year by the Agency, after consultation with the Slovene Institute of Auditors. The tables comprise detailed questions on investment firms’ operations, particularly with regard to compliance with rules on public dissemination of information, use of accounting principles, risk management, implementation of prudential rules, internal control mechanisms, and adequacy of information systems. Similar questionnaires and tables are defined for management companies and investment funds supervised by the Agency. The Securities Market Agency and the Institute of Auditors work closely and collaboratively to coordinate these additional requirements for auditors while auditing investment firms.

- ***Contribution to the supervisory process.*** A bank and insurance statutory auditor carries out specific assignments and issues special reports in accordance with statutes to assist the Bank of Slovenia and Insurance Supervision Agency in discharging its supervisory functions. These duties include reporting upon whether the systems for maintaining accounting records and the systems of internal control are adequate, allowance for loan losses are adequate (banks), and technical provisions are fairly stated (insurance).
- ***Matters of urgent interest to the Bank of Slovenia and the Insurance Supervision Agency.*** The Banking and Insurance Acts require the statutory auditor to communicate to the Bank of Slovenia and the Insurance Supervision Agency their awareness of going concern issues but not instances of fraud or other matters that could result in a qualified or adverse audit opinion.⁷

18. **While the Company Act, since 2002, requires that large- and medium-sized enterprises as well as listed companies, file their annual reports with the Agency of the Republic of Slovenia for Public Evidences and Services (AJ PES), in practice annual reports are not always timely and readily available.** Publication requirements for listed companies are effective in terms of availability but fall short of the forthcoming requirements of the EU Transparency Directive. Listed companies are required to report both non-audited and audited financial statements to the Securities Market Agency. The Agency controls, as well as sanctions those obligations. Public companies must report their non-audited financial statements to the Agency by end-March, their audited annual reports by end-June, and their semi-annual reports by end-August. In addition, they must publish their contents publicly. If a public company fails to meet these obligations, the Agency issues a decision ordering it to comply with the necessary requirements. Additionally, the Agency may refer the case to a misdemeanor court, in accordance with the Securities Market Act. Banks are required to publish their annual report, including audited consolidated and legal entity financial statements within five months of their fiscal year-end.

⁷ Since statutory audits are performed in accordance with International Standards on Auditing, ISA 240, *The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements*, applies. ISA 240 states that “the auditor’s professional duty to maintain the confidentiality of client information ordinarily precludes reporting fraud and error to a party outside the client entity. However, the auditor’s legal responsibilities vary by country and in certain circumstances, the duty of confidentiality may be overridden by statute, the law or courts of law. For example, in some countries (e.g., Belgium, France and Luxembourg), the auditor of a financial institution has a statutory duty to report the occurrence of fraud and material error to supervisory authorities. The auditor considers seeking legal advice in such circumstances.” According to Article 119 of the Banking Act, the auditor is responsible for immediately notifying the Bank of Slovenia of violations of rules.

19. **The Company Act sets out severe administrative fines for not filing audited annual reports.** The requirement to file legal entity and consolidated financial statements was established in 2002. Since the Company Act sets out administrative fines (minimum SIT 3,000,000, equivalent to US\$16,000) for non-filing of the audited annual report, the ROSC team expects a significant improvement in the availability (not the timeliness) of financial statements at the Agency of the Republic of Slovenia for Public Evidences and Services if these fines are actually levied.

20. **Listed companies must issue preliminary unaudited financial statements within two months of the fiscal year-end (and three months for consolidated financial statements).** The preliminary statements must be provided to the Stock Exchange at the same time as they are published. This practice might have a negative impact on the audit process: International experience has shown that auditors undergo increased pressure from the companies not to adjust the financial statements if earnings are released prior to the completion of the audit (and hence the publication). Also, this requirement might not agree with provisions of the forthcoming EU directive on transparency.

B. The Profession

21. **In line with the *acquis communautaire*, the right to conduct statutory audits of financial statements was reserved for members of the Slovenian Institute of Auditors.** The Slovenian Institute of Auditors, which was established in 1993, has 542 individual members, of which 189 are auditors with a license to perform audits. A large part of licensed auditors (approximately 140) actually perform audits within 42 registered audit firms. Others are employed in the public sector, industry, the university, and at the Institute of Auditors. Audit firms include local member firms of international audit firm networks, as well as “truly local firms.”

22. **The leadership of the Slovenian Institute of Auditors in the process of improving accounting and auditing in Slovenia is commendable but self-regulatory arrangements have become anachronistic in current circumstances.** The Institute was set up very early after Slovenian independence and led successful accounting and auditing reforms in Slovenia. The Institute’s governance and self-regulatory arrangements are as follows:

- *The Institute regulates accounting and auditing, as well as valuation services relating to enterprises, and to some degree, to real estate, machinery and equipment. In addition, it develops educational programs (and maintains records of those who have completed such programs) and establishes professional standards in the fields of corporate finance, internal audit, information systems audit, tax compliance and advisory services.* Under the Auditing Act, the Slovenian Institute of Auditors has the following requirements: (a) adopt and publish accounting and auditing standards; (b) organize professional education and examination; (c) organize continuing professional education; (d) maintain registers of auditors, including auditing firms and individuals; (e) determine audit service pricing guidelines; (f) handle complaints against auditors; (g) control the quality of audit activity and members’ professional conduct; and (h) take disciplinary sanctions, including disbarment, against auditors. The Institute’s members include audit firms, certified auditors, auditors, certified management accountants, accountants, certified information systems auditors, certified internal auditors, and certified tax consultants.

A specific body of the Institute of Auditors, the Board of Auditors, is responsible for auditing matters (see paragraph 27 below).

- ***The Institute has very extensive self-regulatory powers and is not accountable to government.*** It only has an annual reporting responsibility to Parliament. This special position is now anachronistic in current circumstances, since recent financial reporting scandals in the United States and the European Union have led authorities and regulators to re-examine the existing self-regulatory regime of the audit profession. The audit's value is in the users' confidence. The current erosion of confidence in the audit profession worldwide is partly based on a public perception that any self-regulating profession runs a risk of conflicts of interest in dealing with its shortcomings. This threat is certainly relevant in Slovenia where the degree of self-regulation is a lot greater than in most EU Member States. The current self-regulatory regime will need to be amended to conform with the requirements set out in the proposal for a new Eighth EU Company Law Directive.

23. **In law, Slovenia implemented most provisions of the EU Directives and Recommendations on auditing and created an environment for implementation of International Standards on Auditing.** The Auditing Act and current practice do not yet comply with all provisions of European Commission Recommendations on auditor's independence (May 16, 2002) and on quality assurance for statutory audits (November 15, 2000). These Recommendations are non-binding instruments and should not be solely relied upon to deliver the necessary degree of rigorous application required by the present situation. Having made this determination, the European Commission issued a proposal for a new Eighth EU Company Law Directive to provide a comprehensive legal basis for all statutory audits conducted within the European Union. Selected areas of difference between Slovenian regulations and the European Commission Recommendations and the proposal for a new Eighth EU Company Law Directive, include the following: (a) The European Commission recommends that quality assurance systems should have adequate public oversight with a majority of nonpractitioners on the oversight board. This public oversight should be conducted with a high level of integrity and assure the quality of reporting in fact and appearance. The existing quality assurance system in Slovenia does not have adequate public oversight; (b) When a *public interest entity* has a governance body (e.g., supervisory board), the European Commission recommends disclosure—both publicly and at least annually in writing to the governance body—of total fees charged by the auditor, the audit firm, and its network members to the client and its affiliates. These fees should be broken down by reporting period into four broad categories of services: statutory audit, further assurance, tax advisory, and other nonaudit. At present, this is neither required by the Slovenian legislation nor generally accepted by the audit profession.

24. **Existing legal civil and criminal provisions relating to auditor's liability do not appear to establish a strong deterrent.** The main issues concerning the current Slovenian legislation of auditors' activities include the following:⁸

- ***Auditors have no automatic liability to third parties.*** The scope of the statutory auditors' duties to the company and to shareholders is set out in the Company Act. The Act is based on the principle that the auditors' statutory report was prepared for

⁸ This report outlines the legal principles applicable with regard to each of the above areas and some miscellaneous issues 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.

the very specific purpose of enabling the members of a company to exercise their rights as members of the company (for example, to vote at a company meeting). This means that auditors have no automatic liability to anyone using their report for deciding on whether or not to extend credit to the company.

- ***The low statutory cap on auditors' liability hampers the effectiveness of auditor liability as a driver for audit quality.*** The Company Act fixes an arbitrary cap on auditors' liability to the audited company and its shareholders. Under the Act, a statutory auditor is responsible to the company and its shareholders for damages caused by the violation of auditing standards, up to a limit of SIT 35,000,000 (US\$187,000), except in cases of gross negligence or deliberateness.
- ***The legal provisions involving an auditor's liability for misdemeanors or criminal acts are ineffective.*** The Auditing Act sets out sanctions for misdemeanors ranging from SIT 500,000 to SIT 5,000,000 (US\$2,700 to US\$27,000) depending on the infringement and whether an individual or a firm committed it. However, for example, sanctions against an audit firm breaching its duty of confidentiality could be a fine between US\$5,400 and US\$27,000 that bears no relationship to the gravity of the offence and resulting damages (e.g., in the context of an initial public offering). The Criminal Act does not define any specific criminal act relating to statutory audits. Certain acts committed by statutory auditors (e.g., falsification or destruction of documents) might be subsumed under articles 240, 244, or 256 of the Criminal Act (e.g., falsification or destruction of documents), but the burden of proof is so high (e.g., intent must be proven and gross negligence does not suffice) that Slovenian lawyers generally contend that prosecuting such a case would not be practicable.

25. **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 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, and the basis for partner remuneration.

C. Professional Education and Training

26. **The accounting curriculum at leading universities is primarily geared to Slovenian Accounting Standards.** Slovenian universities have not adjusted their accounting curriculum to take full account of EU Regulation 1606/2002 requiring the use of International Financial Reporting Standards beginning 2005. Also, in the wake of recent ethics scandals, Slovenian universities have not sufficiently focused attention on business ethics, but have included aspects of it across the university-wide curriculum. Business ethics curriculum needs to be evaluated and revamped. In the opinions of senior finance personnel in leading Slovenian enterprises and audit firms, the average level of accounting education lags behind the needs of the fast-developing Slovenian economy.

27. **The Auditing Act complies with the Eighth EU Company Law Directive of April 10, 1984, on approval of statutory auditors.**⁹ A prospective auditor-trainee must have graduated

⁹ It should be noted that although the Eighth EU Company Law Directive contains some requirements on registration and professional integrity, it does not include requirements on how a statutory audit

from college in a bachelor's program to start a traineeship. A prospective certified auditor qualifies having graduated from college in a bachelor's program, obtaining five years of additional practical experience in auditing, and passing the Slovenian Institute of Auditors' examination. A certified auditor must also have command of the Slovenian language. An aptitude test is prescribed for the approval of statutory auditors from foreign countries, including other EU member states. The professional examination covers subjects mandated by the Eighth EU Company Law Directive and is handled by the Institute's Board of Auditors. The Board of Auditors consists of six members from the audit profession and three non-auditors representing the public interest.

28. **The Slovenian Institute of Auditors does not monitor adequately the quality of the practical experience obtained by individuals (trainees) undertaking pre-qualification work experience and training within audit firms.** Experience required to qualify as a certified auditor is directed by a mentor who is also a member of the Institute. However, the Institute has not established a mechanism for approving suitable training providers. The Institute does not supervise the practical training for quality.

29. **The Slovenian Institute of Auditors requires and effectively enforces continuing professional education (CPE) for its members.** In order to retain his or her qualification, an auditor is required to attend 60 CPE hours every two years. The Institute monitors compliance with CPE requirements and the renewal of an auditor's license every two years depends upon satisfactory compliance with CPE requirements.

D. Setting Accounting and Auditing Standards

30. **The Slovenian Accounting Standards Committee of the Slovenian Institute of Auditors prepares Slovenian Accounting Standards, which are enacted by the Professional Council of the Institute.** The Committee comprises six members and a permanent chairperson who are appointed by the Professional Council of the Institute. Among the members, two are university professors, two are certified auditors, and two are certified accountants employed as preparers of financial statements. The Professional Council of the Institute is composed of eleven members, including nine members of the Institute and two university professors. A three-member working group is appointed by the Committee and entrusted with the drafting of a specific Slovenian Accounting Standard. The working group comprises a university professor, a certified auditor, and a certified internal accountant employed as preparers of financial statements.¹⁰ The working group presents a draft standard to the Committee, which reviews it and presents it to the Professional Council. When approved by the Council, the draft is published in the Institute's publication for public consultation. The minimum comment period is three months. The working group revises the draft based on the comments it receives and presents a final draft to the Committee, which reviews it and presents it to the Professional Council. When approved by the Council, the standard is published in the Official Journal of the Republic of Slovenia, in the Institute's publication, and in a handbook published by the Institute.

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.

¹⁰ A working group may also include subject matter experts who need not be members of the Slovenian Institute of Auditors.

31. **The accounting standard setting process has made a significant contribution to the enhancement of accounting in Slovenia but areas for improvement remain.** Selected areas for improvement include:

- ***Involvement of other stakeholders.*** While the standard setting process allows for public consultation, other stakeholders (e.g., regulators, users) are not actively involved in the process. There is no public oversight of the Institute of Auditors.¹¹ Also, the meetings of the Committee are not open to public observation. Finally, when the Professional Council publishes a standard, it does not publish a Basis for Conclusions to explain publicly how it reached its conclusions and to give background information that may help users of the standards to apply them in practice. The Council does not publish the comments received on the exposure draft and dissenting opinions.
- The Institute has not established an urgent issues task force to deal with urgent matters not covered by existing standards and for which the normal standard setting process is not appropriate or practical. Therefore, preparers generally turn to the audit profession to develop interpretations. As recent 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.

32. **Accounting standards for banks are supplemented by certain regulations issued by the Bank of Slovenia.** The Bank of Slovenia issues prudential regulations that have an impact on the preparation of financial statements. For example, the regulations on classification of assets and on provisioning determine loan loss allowances (see paragraph 40 below). The Securities Market Agency and the Insurance Supervision Agency do not set accounting standards per se, although the Insurance Supervision Agency does issue some prudential regulations that have an impact on the preparation financial statements of insurance companies (e.g., issued a decision on rules and minimum standards relating to the calculation of technical provisions, and on the method of valuation of accounting items and compiling financial statements).

33. **The Auditing Act requires that statutory audits be carried out in accordance with auditing rules adopted by the Slovenian Institute of Auditors as well as with International Standards on Auditing.** The Slovenian Institute of Auditors has enacted basic auditing rules and a code of conduct. The law further requires that statutory auditors apply International Standards on Auditing and hence the International Federation of Accountants (IFAC) Code of Ethics for Professional Accountants (revised in November 2001). An Institute review indicates no inconsistency between these legislative texts.

E. Enforcing Accounting and Auditing Standards

34. **The Securities Market Agency is not geared to enforce accounting standards.** After the listed companies have their abridged financial statements published in the press, the Securities Market Agency reviews them for coherence and completeness and agreement with the full audited financial statements. The Securities Market Agency does not enforce accounting standards and relies primarily on statutory auditors to ensure compliance with accounting standards. Inadequate enforcement of accounting standards result from two major weaknesses:

¹¹ Only the Board of Auditors (see paragraph 27) is comprised of a minority of members who are non-auditors.

- ***Inadequate statutory framework.*** The Securities Market Agency has very limited authority over securities issuers and has no general duty to protect shareholder rights. Also, the Securities Market Agency staff has no specific legal protection against personal lawsuits for their professional activities, even when conducted conscientiously and in good faith. The law does not provide the Securities Market Agency with authority—under specific circumstances and defined procedures—to request audit work papers and compel the production of documents or the attendance of witnesses. The Securities Market Agency does not have the authority to fine companies, directors, or officers but must refer all infringements to a misdemeanor court. This is a cumbersome and ineffective process to handle small infringements (e.g., late filing).¹² Finally, as discussed in paragraph 10 above fraudulent financial reporting is not a criminal offense.
- ***Inadequate resources.*** The Securities Market Agency lacks personnel with adequate training to adequately enforce accounting standards. While the SMA staff possess strong theoretical knowledge and are highly motivated and flexible, it is inadequate for recognizing the potential shams by market participants and fully understanding the complexity of transactions and financial information. Also, the Securities Market Agency lacks adequate resources to play an active role in the Committee of European Securities Regulators (CESR).

35. **Listed companies are ill-prepared to apply IFRSs beginning in 2005; audit firms are likely to face capacity constraints, and the Securities Market Agency lacks enforcement powers and capacity to properly and rigorously enforce IFRSs.** EU Regulation 1606/2002 on the use of IFRSs requires companies, whose equity securities are admitted to trading on a regulated market (hereinafter “listed companies”), to prepare IFRS-based consolidated financial statements beginning in 2005. Approximately 100 Slovenian listed companies,¹³ though facing IFRS-implementation requirements beginning 2005, have yet to enhance their accounting information systems and train their finance personnel. Not all audit firms may have the capacity to conduct quality audits of IFRS financial statements especially in an environment where preparers of financial statements struggle to comply with IFRS requirements. Finally, the Securities Market Agency lacks enforcement powers and capacity to properly and rigorously enforce IFRSs as required by Recital 16 of EU Regulation 1606/2002. Among the shortcomings noted by the ROSC team, the Securities Market Agency does not have resources sufficient to establish and carry out an effective monitoring system, including enough professionally skilled staff experienced with IFRSs. Also, assuming the Agency detected a material misstatement in financial statements, it could not take swift appropriate actions to achieve an appropriate disclosure and, where relevant, public correction of the misstatement (in line with the requirements of the reporting framework).

36. **The Bank of Slovenia enforces accounting standards within financial statements of banks.** The Bank of Slovenia reviews banks’ statutory financial statements, but the primary responsibility rests with the auditors. The Bank of Slovenia has too few staff with significant expertise in bank accounting matters. While this small group of experts appears to be very knowledgeable about bank accounting issues, the size of the staff is insufficient given the important role the Bank of Slovenia plays in enforcing Slovenian Accounting Standards in the banking sector.

¹² From January 1st, 2005 on the Agency will have the power to decide on misdemeanor sanctions on the first degree in accordance with the new Misdemeanor Act.

¹³ Among 134 listed companies (see paragraph 5), approximately 100 companies have subsidiaries and hence present consolidated financial statements.

37. **The Slovenian Institute of Auditors has established procedures for quality control of statutory audits but there remain areas for improvement.** The main features and areas for improvement of the existing system include the following:

- ***Sole practitioners and audit firms are subjected to the Institute’s quality assurance system.*** The Institute employs four reviewers, supplemented by auditors in public practice, to form a review team. The review team assesses the internal quality control system of the reviewee (sole practitioner or audit firm) and tests the procedures and audit files for full compliance with International Standards on Auditing.
- ***Audits of IFRS-based financial statements are not under the purview of the Institute.***¹⁴ Until International Financial Reporting Standards become statutorily applicable in Slovenia, audits of IFRS-based financial statements fall outside the scope of the quality review system, which was established pursuant to the Auditing Act and does not extend to “contractual” audits. It is unclear whether the public and the regulators understand this important distinction, since stakeholders appear to be under the impression that audits of IFRS-based financial statements are better than audits of SAS-based financial statements. While this issue is not covered by the *acquis* and there is no internationally accepted practice that could be used as a benchmark, this is a significant worry in Slovenia where audited IFRS-based financial statements are primarily prepared by *public interest entities*.
- ***The cycle to achieve full coverage of all statutory auditors is adequate.*** The Slovenian Institute of Auditors reviews approximately 40 audit firms or auditors per year, which achieves full coverage in a three-year cycle for public interest entities and in a five-year cycle for other companies, which is in line with the *acquis communautaire* and good practices.
- ***The results of quality assurance are published by the Institute.*** Publication of quality assurance results adds public credibility to the quality assurance systems. The Institute recently started publishing results of the quality assurance naming individual auditors or audit firms.
- ***The quality assurance system does not have sufficient public oversight.*** The Board of Auditors, which oversees the quality assurance system, does not consist of a majority of non-auditors. This falls short of the requirements of the looming *acquis* and good practices and weakens the credibility required to sustain public confidence (in Slovenia and abroad) that the Institute adequately discharges its self-regulatory responsibilities.¹⁵
- ***Confidentiality requirements need to be reviewed to allow public oversight of the quality assurance system.*** Legislation does not include adequate provisions overriding the auditor’s duty of confidentiality to permit adequate public oversight of the quality assurance system (e.g., involving the Bank of Slovenia, the Insurance Supervision Agency, and the Securities Market Agency), except in limited circumstances as, for example, set out in Article 119 of the Banking Act.

¹⁴ As discussed in paragraph 47, many Slovenian *public interest* entities prepare IFRS financial statements.

¹⁵ For *public interest entities*, the European Commission proposed that the oversight of auditors should be carried out exclusively (as opposed to a “majority”) by non-practitioners.

- ***The Institute has allocated dedicated resources to the quality assurance system in order to give it a realistic impact.*** The Institute levies fees from the reviewees in order to carry out quality assurance reviews. The funding for these reviews may not be perceived as secure and free from possible undue influence by statutory auditors or audit firms.

38. **As granted by the Auditing Act, the Slovenian Institute of Auditors has authority to investigate and issue sanctions to detect, correct, and prevent inadequate execution of the statutory audit.** The Auditing Act provides effective disciplinary penalties (reprimand, temporary or permanent suspension) with respect to statutory auditors and audit firms when statutory audits are not carried out in conformity with the law. Under the present rules, appeals against disciplinary sanctions may be lodged with the High Court of Justice. It is not clear whether the existing system of quality assurance and disciplinary sanction complies with the requirements of natural justice and particularly the European Convention on Human Rights¹⁶ since there does not appear to be an appropriate separation of functions built into the system. Confidence in the effectiveness of the Institute's disciplinary sanctions has eroded since the Institute has only issued reprimands and one suspension. Observers, including foreign investors, commercial banks (lenders), and members of the audit profession point to cases where the Institute should have taken more stringent sanctions against auditors who failed to comply with auditing standards or the code of ethics (see paragraph 46 below). This lack of public confidence is partly based on a perception that any self-regulating profession runs a risk of conflicts of interests in dealing with its shortcomings. This perception reinforces the urgency of establishing an adequate public oversight mechanism.

III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

39. **While recent changes to Slovenian Accounting Standards contributed to enhanced transparency, remaining weaknesses still impede reliability and comparability.** Until December 31, 2001, there were many more differences between the then Slovenian Accounting Standards and IFRSs. The most significant of these differences was that SAS required a form of current cost purchasing power accounting i.e., certain assets and liabilities and equity were required to be revalued for annual inflation as measured by changes in the consumer price index. The result of such revaluation was debited or credited to the income statement. The accounting treatment required was broadly in line with the general purchasing power approach in IAS 15, *Information Reflecting the Effects of Changing Prices*, and IAS 29, *Financial Reporting in Hyperinflationary Economies*, with the obvious problem that Slovenia was not hyperinflationary. Slovenian Accounting Standards changed dramatically with effect from January 1, 2002, and this revaluation, while theoretically possible, was not in effect for 2002, should not be in effect for 2003 and is generally not expected to rear its head again in the future as further harmonization or adoption of IFRS is anticipated. While the changes in Slovenian Accounting Standards can generally be considered to have been a massive step toward harmonization with International Financial Reporting Standards, some fundamental differences remain and SAS may not provide the general public with sufficient information about *public interest enterprises*. Selected differences include the following:

- ***Capitalization of foreign exchange losses.*** SAS 9, *Long-term Liabilities*, requires that foreign exchange differences arising on reporting an enterprise's long-term liabilities at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognized as an

¹⁶ Incorporated in the 1998 Human Rights Act.

adjustment to the acquisition cost when the debt is associated with the acquisition of a tangible or intangible asset. Such capitalization could result in overstated tangible and intangible assets. For example, the reported acquisition cost of an asset acquired with a Euro denominated loan in 1998 would have been increased by approximately 15 per cent by the end of 2002, due to the decrease in the value of the Slovenian Tolar between 1998 and 2002. IAS 21, *The Effects of Changes in Foreign Exchange Rates*, requires that foreign exchange losses be expensed.

- **Broader definition of extraordinary items.** The definition of extraordinary items under SAS 17, *Expenses*, is somewhat broader than under IFRSs. It specifically includes expenses resulting from the recognition of provisions for potential losses. Recognition of these provisions under SAS 17 is generally consistent with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, although it lacks the specificity of IAS 37, which may result in significant compliance gaps.¹⁷ However, the classification of related expenses as extraordinary expenses does not conform with IFRSs.
- **Capitalization of start-up costs.** Under SAS 2, *Intangible Fixed Assets*, start-up costs must be capitalized and amortized over a period deemed to reflect their useful life. The maximum amortization period allowable is 20 years. IAS 38, *Intangible Assets*, requires all expenditure on starting up an operation or a business to be recognized as an expense when it is incurred. SAS 2 may result in overstating the assets of an enterprise and mislead users.
- **Treasury stock is recorded as an investment.** SAS 3 requires the recording of costs incurred by an enterprise to re-acquire its own equity instruments as a financial asset. Although this is in line with the Fourth EU Company Law Directive, it does not conform with IFRSs, which require that the cost be deducted from equity, and may mislead users of financial statements when assessing capital adequacy.
- **Long-term receivables are recorded as current assets.** SAS 5, *Receivables*, requires that long-term receivables be shown as current assets in the balance sheet. Such presentation is in line with the Fourth EU Company Law Directive, although it does not conform with IFRSs.

40. **There are specific differences between International Financial Reporting Standards and Slovenian Accounting Standards pertaining to banks.** Bank-related accounting standards are primarily set out in the regular body of Slovenian Accounting Standards issued by the Slovenian Institute of Auditors and supplemented by Bank of Slovenia regulations on the classification of assets and on provisioning. Selected differences include the following:

- **Allowance for loan losses.** A Bank of Slovenia Regulation requires banks to calculate impairment in the unsecured portion of loans and receivables based on a provisioning matrix that specifies a range of fixed provisioning rates for each loan category (such as 5 to 15 percent if the loan belongs to category B, 15 to 40 percent for category C, etc.).¹⁸ The Bank of Slovenia Regulation is consistent with generally

¹⁷ IAS 37 requires that an enterprise has to recognize a present obligation resulting of a past event when it is probable (i.e., more likely than not) that an outflow of resources embodying economic benefits will be required to settle the obligation; and a reliable estimate can be made of the amount of the obligation.

¹⁸ To further explain loan category by example, category B includes loans to a borrower whose cash flows are assessed as adequate to duly meet its due obligations, but whose financial position is currently weak, without signs of significant deterioration in the future or who often repays his obligations with a delay of up to 30 days, occasionally also with a delay between 31 and 90 days.

accepted regulatory accounting practices. However, this methodology may not comply with IAS 39, *Financial Instruments: Recognition and Measurement*, 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.

- ***Disclosure of off-balance-sheet activities.*** Slovenian Accounting Standards generally require the use of fair value and certain disclosures, somewhat in line with those required under IAS 32, *Financial Instruments: Disclosure and Presentation*, on exposure to credit, foreign exchange and interest rate risk. However, the whole area of disclosure of off-balance-sheet activities is limited. Items such as derivatives are generally not discussed or disclosed.

41. **There are specific differences between Slovenian Accounting Standards pertaining to insurance companies and IFRSs.** Insurance-related accounting standards are primarily set out in the regular body of Slovenian Accounting Standards issued by the Slovenian Institute of Auditors and supplemented by the Insurance Supervision Agency regulations on technical provisions. Selected differences include the following:

- ***Broad use of the equalization provision allows Slovenian insurance companies to smooth loss ratios.*** Slovenia allows the use of the “deferral and matching” approach rather than the “asset and liability” approach adopted by the IASB. Therefore, insurers can recognize equalization provisions as technical provisions for most non-life insurance risks.¹⁹ This conflicts with the European Union Insurance Accounts Directive, which permits the use of equalization provisions only for selected insurance risks. Slovenian accounting requirements allow insurance companies to smooth loss ratios over a ten-year period. As a consequence, an insurance company's profit or loss for the year is no longer representative of the company's actual profitability, cannot be compared to other entities' profits, and can hardly be used as a basis to monitor management's performance. While equalization provisions should be eliminated to conform with the *acquis* and IFRSs, their elimination should not undermine insurers' solvency. It should address their underlying risk profiles in the context of profit distribution within equity. The application of adequate solvency calculations and risk-based capital techniques within equity will indicate the level of surplus to be retained in order to fund the losses that emerge from the insurance protection.
- ***The methodology to discount technical provisions for pending claims falls short of internationally accepted practices.*** Insurance companies are required to discount provisions for pending claims only when those are expected to be paid in four years or more. Determining whether a claim will be settled in three years—and hence does not have to be discounted—or five years—and hence should be discounted—may be very arbitrary (e.g., in cases of claims related to low frequency risks, claims subject

¹⁹ Certain insurance and reinsurance contracts cover rare events such as nuclear risks and earthquakes. When these occur, the policyholder is entitled to an indemnity from its insurer. Some jurisdictions allow (or require) insurers to create a liability to meet the potential future cost of these claims. These “catastrophe” or “equalization” provisions are built up by setting aside an element of the annual premiums received by insurers on certain policy types. The provisions are released against the payment of the insured amount in the financial year when the insurer is notified of the loss. The provisions are intended to pay for future events; this means they conflict with the definition of a liability in the IASB Framework.

to settlements or court rulings). More importantly, an insurance actuary generally evaluates the expected timing for all claim settlements and determines whether discounting is required or not. Reference to an arbitrary four-year cut-off number does not conform with internationally accepted practices. The Insurance Supervision Agency made an effort to supplement SAS 32 by issuing a Decision on detailed rules and minimum standards relating to the calculation of technical provisions, which purports to comply with the EU Insurance Accounting Directive.

42. **The ROSC team made assessments of the compliance gap with eight sets of financial statements prepared in accordance with International Financial Reporting Standards and nine sets of financial statements prepared in accordance with Slovenian Accounting Standards.**²⁰ For the sample review, the ROSC team selected nine enterprise sector companies (listed and unlisted), six banks, and two insurance companies. The quality of the SAS and IFRS financial statements of most *public interest entities* is generally very high with only a few relatively minor issues. The accounting policies and disclosures are generally very clear. Significant issues, arising when there may be material non-compliance with SASs or IFRSs, also raise questions about the audit opinion:

- ***Discrepancies between actual accounting policies followed by financial institutions and the “boilerplate” disclosures in their IFRS financial statements.*** A number of banks indicated that they calculate impairment in the unsecured portion of loans and receivables on the basis of the Bank of Slovenia provisioning matrix that specifies a range of fixed provisioning rates for the number of days a loan has been classified as nonperforming (see paragraph 40 above). The ROSC team is unable to determine the materiality of such a departure from IAS 39. The ROSC team is also concerned that the disclosed accounting policy is based on compliance with IAS 39 when the banks are, in fact, applying a different policy.
- ***Inadequate measurement of loan losses (banks) and bad debts (corporates).*** In a few instances, banks and corporates disclosed an accounting policy for the measurement of loan losses and bad debts that may not comply with IAS 39. For example, a corporate recognizes a provision for bad debts on trade receivables based on the age of the receivable. A provision of 100 percent is made for amounts over 60 days past due (with the exception of large customers) and 70 percent for other doubtful and disputed receivables. This method may not comply with IAS 39, which requires that provisions be based on recoverable amount rather than an age analysis.
- ***Improper capitalization of foreign exchange losses.*** In a number of instances, property and equipment purchased from abroad is revalued for changes in exchange rates relating to any outstanding, related debt. This does not comply with IAS 21, *The Effects of Changes in Foreign Exchange Rates*, which requires the measurement of such assets using the exchange rate at the date of acquisition and the recognition of any subsequent exchange gains and losses on related debt as income or expenses. The policy adopted by some Slovenian companies has the effect of adding any exchange losses to the cost of the related assets.

²⁰ 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.

- **Possible noncompliance with business combination accounting requirements.** An acquisition of one enterprise by another involves determination of the cost of the acquisition, allocation of the cost over the identifiable assets and liabilities of the enterprise being acquired, and accounting for the resulting goodwill or negative goodwill. IAS 22, *Business Combinations*, requires that the cost of an acquisition be allocated to the acquired identifiable assets and liabilities. In several instances the acquirer assumed that the net book value of acquired property and equipment equaled their fair value. Where significant property and equipment was acquired, this may be a material departure from IAS 22, which requires that plant and equipment be recognized at market value, normally determined by appraisal.

43. **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 Slovenian Accounting Standards in various areas (e.g., depreciation, revenue recognition, provisions). Transparency and accountability suffer from this emphasis on tax and deviation from applicable financial reporting standards.

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

44. **The local member firms of international audit networks appear to apply different internal quality assurance procedures for “offshore” audits than for statutory audits.** For example, the firms will assign audits of IFRS-based financial statements to an independent partner desk review—often performed by an IFRS expert abroad. Such desk reviews may be effective in ensuring that audited IFRS-based financial statements appear to conform with International Financial Reporting Standards, but there may be significant differences between disclosed accounting policies and actual practices (see Section IV above). The ROSC team notes that such practices raise two issues:

- **The firms appear to have a double standard.** The audit firms may implement additional quality assurance for “offshore” audits because the perceived reputation or litigation risk is greater than for statutory audits. This begs the question as to whether audit firms actually believe internal quality arrangements they apply in the context of statutory audits are sufficiently robust. Audited Slovenian Accounting Standards-based financial statements are widely used in Slovenia. For example, regulators are among the primary users of audited Slovenian Accounting Standards-based financial statements, since they look to the statutory auditor for assistance in areas for which the auditor’s skills are expected to be particularly suited.
- **Compliance in form may not be compliant in substance.** While desk reviews do contribute to the quality of an audit, fieldwork is fundamental to audit quality. Audit firm staff and financial statement preparers often commented that disclosed accounting policies—reflecting comments from senior audit partners at IFRS desks abroad—differ from actual accounting practices within the audited company. The concern is that IFRS-based financial statements may be complying in form but not in substance.

45. **Few shareholders, directors, and members of management understand the purpose of an audit, which makes obtaining audit evidence difficult.** Despite the efforts of many audit firms to carry out audits in accordance with International Standards of Auditing, they must still

contend with the client's lack of audit experience. While this problem undoubtedly occurs in other countries, including those with developed audit laws and practice, the extent of some problems is more widespread in Slovenia than in other countries (see paragraph 10 above). There is an obvious need for more education of investors, directors, and members of management that has been addressed under the ROSC corporate governance module.

46. **Observers point to certain problem areas adversely impacting average audit quality.** Selected problem areas adversely impacting the *average* quality of auditing practices in Slovenia emerged during discussions conducted by the ROSC team with preparers of financial statements, lenders, investors, regulators, sole practitioners, small and large audit firms, and the Slovenian Institute of Auditors.

- ***Overvalued assets.*** Slovenian Accounting Standards and International Financial Reporting Standards require not carrying assets at more than their recoverable amount. The resulting impairment charge is tax deductible. Observers point to the fact that impairment charges were mainly recorded by profit-making companies in an effort to reduce their taxable income, whereas loss-making companies generally refused to record impairment charges. Auditors have generally expressed an emphasis of matter audit opinion rather than a qualified audit opinion when they noted such instances of noncompliance. This is a lenient and, most would argue, incorrect audit opinion under International Standards on Auditing. Such an audit opinion does not adequately protect the public. These overvalued assets present a rosier picture of the company's financial position than actually exists.
- ***Inadequate disclosure of related parties.*** Strict application of the international good practice on auditing related-party transactions seems to give rise to tension between the auditor and management and may result in inadequate disclosure of related party transactions.

V. PERCEPTIONS ON THE QUALITY OF FINANCIAL REPORTING

47. **Increased demand for transparency in financial statements has developed among shareholders, investors, and lenders.** The demand for financial statements has increased. Key drivers for the demand for financial statements include:

- ***Commercial banks.*** Bank of Slovenia regulations require that borrowers' financial statements for the three most recent fiscal years be on file. In addition, a few foreign invested banks are introducing credit-pricing strategies that draw, inter alia, upon the borrower's financial statements.
- ***Correspondent banks and listed companies.*** Most banks present financial statements that purport to be IFRS compliant since these are generally requested by correspondent banks. A number of large (listed) companies present consolidated financial statements that purport to be IFRS compliant to satisfy the requirements of foreign investors or creditors.

VI. POLICY RECOMMENDATIONS

48. **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 auditing and accounting report sketches the policy recommendations to enhance the quality of corporate financial reporting. This will contribute to promoting private sector growth and reducing volatility, through:

- strengthening the country's financial architecture and reducing the risk of financial market crises, and their associated negative economic impacts;
- contributing to foreign direct investment and helping to mobilize domestic savings;
- facilitating the access of smaller-scale corporate borrowers to credit from the formal financial sector by lowering the barrier of high information and borrowing costs;
- 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
- facilitating the country's integration into the European Union.

Financial reporting is also a building block of a market-based monitoring of companies, which allows shareholders and the public at large to assess management performance, thus influencing its behavior.

49. **Significant changes to the statutory framework, especially self-regulation of the audit profession, and its implementation are needed.** Accounting and auditing are primarily regulated by the Company Act, the Auditing Act, the Securities Market Act, the Banking Act, the Insurance Act, and related secondary legislation. These may need amending to incorporate the following legislative recommendations:

- **Increase public oversight of accounting standard setting and the audit profession.** As deficiencies of self-regulatory arrangements become clearer on the international scene, the current accounting and audit profession self-regulatory arrangement should be balanced with an adequate oversight system, which is currently lacking. The authorities should make that the public oversight system is in line with the proposal for a new Eighth EU Company Law Directive. The objective of public oversight of the accounting and audit profession is to improve public confidence and the credibility of high quality financial reporting.

The public oversight mechanisms should evaluate whether (1) the framework for setting accounting and auditing standards is appropriate, and (2) the mechanisms to ensure that these standards are applied and enforced in practice are adequate. There are a variety of ways of providing such oversight, which broadly fall in two different categories: (a) regulation by Government or under Government's auspices and (b) self-regulation by the accounting and audit profession with an external system of oversight endorsed by Government:

- (a) In some countries, the Government decides to use the expertise available in public bodies such as securities regulators or establish a new specialized body (e.g., the Public Company Accounting Oversight Board in the United States) to deal with these issues, monitor compliance and look after enforcement.
- (b) In other countries, self-regulation is used to secure that the members of a profession observe updated legal and professional requirements and standards in performing their tasks. The objective of oversight of the self-

regulatory activities of the profession is to ensure that accounting and auditing standards are set in the interest of the public, and that the profession conducts audits at a high level of quality, which attracts public confidence in statutory auditing, etc.

In the context of Slovenia, the ROSC team expresses a preference for a mechanism which combines the benefits of significant accounting and auditing expertise (at the Slovenian Institute of Auditors) with the benefits in terms of public confidence of independent non-practitioners. Also, the ROSC team advocates the creation of an independent institution to ensure flexibility and facilitate the association of different stakeholders and experts to the process.

The ROSC team therefore proposes to create a Financial Reporting Council (FRC) to regulate accounting and auditing. This concept brings together a number of different structures, including regulators, that currently exist under the umbrella of one organization, thus harmonizing and rationalizing several disparate sets of oversight regimes with the resulting savings in cost and increase in consistency, uniformity and predictability of regulation of accounting and auditing.

The FRC should be independent of the industry that it regulates and free from undue political pressure. Therefore, it should be governed by non-auditors who are knowledgeable in the areas relevant to accounting and statutory audit. The FRC should have the authority to engage in cooperative enforcement with other governmental agencies and with foreign regulatory authorities. The FRC could include the following committees:

- *Accounting Standards Committee.* The Committee would oversee Slovenian accounting standard setting and related activities undertaken by the Slovenian Institute of Auditors.
- *Statutory Audit Committee.* The Committee would 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.

The Committee should supervise the quality assurance system organized by the Slovenian Institute of Auditors but must have the right, where necessary, to conduct its own investigations on statutory auditors and audit firms. The FRC should have authority to (a) impose non-judicial, administrative sanctions against preparers of financial statements and auditors for violations, (b) file a civil case in court seeking judicial remedies for violations of regulations and laws, and (c) have the authority to refer matters to criminal authorities for criminal prosecution.

The European Commission proposed to allow a minority of auditors to participate in the governance of the system of public oversight. However, the proposed EU Eighth Directive states that this option would not apply to the governance of the public oversight system concerning statutory auditors and audit firms that carry out statutory audits on *public interest entities*. The membership of the Committee should conform with the final Directive's requirements.

- *Financial Reporting Monitoring Committee.* The Committee should have a systematic program for the review of audited financial statements prepared

by *public interest entities*. The Committee would forward its conclusions to the FRC Management Board along with recommendations on the nature of sanctions to be imposed on the preparers and auditors of the financial statements, if applicable. The Management Board would take final decision on sanction(s) and take necessary steps for implementation of the sanction(s). The Committee should develop strong capacity to conduct in-depth review of corporate financial statements in order to determine the extent of compliance with the standards and regulations—not only in appearance but also in substance. The analyst group responsible for conducting the review may consist of a mixture of full-time and part-time experts engaged by the FRC.

The Committee would bring together the IFRS enforcement function of the Bank of Slovenia, the Insurance Supervision Agency, and the Securities Market Agency under its umbrella. Based on the size of the market and the need to further develop IFRS enforcement capacity, bringing IFRS enforcement under the umbrella of one body would result in savings in cost and increase in consistency of IFRS enforcement.

The principles underlying the work of the Committee are similar to those set out under the recommendations pertaining to the Securities Market Agency in paragraph 50 below.

- ***Although not currently required by the EU, Slovenia should extend mandatory application of IFRS to all public interest entities.*** From 2005, listed companies will be required under EU Regulation 1606/2002 to prepare their consolidated financial statements in accordance with International Financial Reporting Standards. This requirement should be extended to other *public interest entities*, in order to better serve the needs of financial statements users. Slovenia may use its existing definition of “large enterprises” as a proxy for public relevance, since it encompasses the three criteria: (a) having securities listed, (b) the nature of the business (for example banks and insurance companies), and (c) the size of the business. This recommendation goes beyond the requirements of the current *acquis communautaire*.
- ***Increase the accountability of preparers of financial statements.*** With a view to enhancing directors’ accountability, all board members should be collectively responsible for the true and fair view of financial statements by law and in practice. To strike a balance, Slovenia does not want regulations and practices so stringent that honest, capable people are put off from serving on boards, but equally the law and practice must be robust to deal fairly when something goes wrong. The ROSC team recommends that a panel of Slovenian experts ensure that the Company Act and its implementation (i.e., the judiciary) provide the right framework for companies to do business, by ensuring that Slovenian criminal and civil directors’ liability provisions conform with company law best practices.²¹

In addition, the panel may review the Company Act in line with the proposal for a new Eighth EU Company Law Directive, which defines minimum standards

²¹ The High Level Group of Company Law Experts, which was set up by the European Commission in September 2001 to make recommendations on a modern regulatory framework in the EU for company law, recommended that the board should be collectively responsible for the probity of financial statements of the company: in a one-tier structure, this is a collective responsibility of both executive and non-executive directors, and in a two-tier structure, this is the collective responsibility of both the managing directors and the supervisory directors.

applicable to the role of audit committees in supervising the audit function, both in its external aspects (e.g., selecting the external auditor for appointment by shareholders, monitoring the relationship with the external auditor including non-audit fees) and its internal aspects (e.g., reviewing the accounting policies).

- ***Ensure shareholders approve consolidated financial statements based on the opinion of the supervisory board.*** Members of the management board should be subject to severe sanctions for failing to submit consolidated financial statements to the supervisory board and shareholders. Shareholders and supervisory board members are concerned with the financial position, results of operations, and changes in financial position of the group as a whole. Their need for this information is served by consolidated financial statements, which present financial information about the group as that of a single enterprise without regard for the legal boundaries of the separate legal entities.
- **Enhance audit regulation to strengthen audit quality.** In addition to public oversight requirements, the legislature should incorporate the provisions within the proposal for a new Eighth EU Company Law Directive—once it is adopted by the European Council and Parliament—including the following:
 - Ensure that the legal provisions regarding dismissal and resignation of statutory auditors provide adequate safeguards for his or her independence. In line with the looming *acquis*, the law could introduce the principle that the statutory auditor or audit firm can only be dismissed if there is a significant reason why the statutory auditor cannot finalize the audit.
 - Undertake a detailed assessment of the professional liability of auditors under Slovenian Law. The assessment should be conducted by a panel of experts independent from the audit profession and make recommendations to enhance the rules on liability of auditors and the fact situation so they are conducive to statutory audit quality.
 - 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. This 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.
 - Ensure pricing guidelines do not impede competition and monitor changes in the *acquis* resulting from recent consultations on regulation in the field of liberal professions and the Lisbon declaration.
 - Require that fees for statutory audit and other services be disclosed. This would allow users to assess whether the fees for statutory audits are approximately adequate to allow proper audit quality; and are not influenced or determined by the provision of additional services to the audited entity.

- **Enhance the authority of regulators over audit firms.** The Bank of Slovenia and the Insurance Supervision Agency leverage the work of statutory auditors in a coherent and well-organized framework. The legislature may want to harmonize and clarify the legal requirements regarding the relationship between the auditor and the Securities Market Agency in line with existing arrangements for the Bank of Slovenia and the Insurance Supervision Agency. The ROSC team recommends that the law give the regulators more authority over audit firms that carry out statutory audits of *public interest entities*. This could be done in the broader context of the proposed FRC.
- **Enhance financial transparency requirements.** Slovenia may also want to incorporate legally the requirements of the new EU Directive on the harmonization of transparency requirements with regard to information about issuers whose securities are admitted to trading on a regulated market. While financial statements are usually readily available, the Directive will shorten the deadline for submission of annual financial statements and introduce a requirement to present half-yearly and quarterly financial statements.

50. **The Securities Market Agency should enhance its monitoring and enforcement arrangements in line with the requirements of Recital 16 in the EU Regulation 1606/2002 on IFRS application.** Enforcement comprises a cascade of different elements, including (1) clear accounting standards, (2) timely interpretations and implementation guidance, (3) statutory audit, (4) monitoring by supervisors and (5) effective sanctions. Each of these must work efficiently: the system will be as strong as its weakest part in delivering strong investor and creditor protection. The Securities Market Agency has a critical role in ensuring that listed companies comply with financial reporting requirements. There is clearly a major interest in ensuring accurate and consistent application of accounting standards in the securities markets the Securities Market Agency oversees. Therefore the financial reporting enforcement role of the Securities Market Agency should be enhanced as follows:²²

- **Securities Market Agency's monitoring objectives.** The ROSC team suggests that IFRS compliance by listed companies should be formally adopted in the Securities Market Agency's monitoring objectives. If Slovenia decides to create the proposed Financial Reporting Monitoring Committee (see paragraph 49 above), the role of the Agency should be adapted so that the Agency would primarily engage in cooperative enforcement with the proposed Financial Reporting Monitoring Committee of the FRC. The principles below would obviously remain applicable.
- **Coordination at the European level.** While enforcement of accounting standards is arranged at the national level rather than at the European level, enforcement arrangements should provide for an international coordination mechanism in order to create a level playing field across the EU and to ensure consistent decisions. To that end, the ROSC team recommends that the Securities Market Agency plays a more active role in the Committee of European Securities Regulators (CESR) and

²² As indicated in paragraph 49, the ROSC team recommends the creation of a Financial Reporting Monitoring Committee, which would take over the accounting enforcement function of the Securities Market Agency. If the Committee were established, the recommendations above would obviously apply to the Committee rather than the Agency.

adopts/implements the standards on enforcement issued by CESR in March 2003 and April 2004.²³

- **Definition of enforcement.** The completeness, accuracy and truthfulness of the financial information is under the responsibility of the issuer's board of directors. Statutory auditors act as a first external line of defense against misstatements by expressing their opinion on the financial information based on their audit. The Securities Market Agency should monitor compliance of the financial information presented by listed companies with IFRS, and take appropriate measures in case of infringements discovered in the course of enforcement.
- **Necessary powers.** The necessary powers of the Securities Market Agency should at least include power to monitor financial information, require supplementary information from issuers and statutory auditors, and take measures consistent with the purposes of enforcement. The Securities Market Agency should be responsible for the setting up of an appropriate due process of enforcement and the implementation of that due process. The Securities Market Agency should therefore be provided with resources sufficient to establish and carry out an effective monitoring system. This includes having professionally skilled staff that should be experienced with IFRS and the legal implications of enforcement.
- **Issuers and documents.** Financial information should include annual and interim financial statements and reports, prepared on individual and consolidated basis as well as prospectuses and equivalent documents.
- **Methods of enforcement.** For financial information other than prospectuses ex-post enforcement is the normal procedure. For prospectuses ex-ante approval is the normal procedure as specified by the EU Directives, which also identify the nature of the approval. Enforcement of all financial information is normally based on selection of issuers and documents to be examined. The preferred models for selecting financial information for enforcement purposes are mixed models whereby a risk-based approach is combined with a rotation or a sampling approach. Methods of enforcement on selected information cover a wide spectrum of possible checking procedures, ranging from pure formal checks to in-depth substantive in-nature checking. The level of risk should normally determine the intensity of the review to be performed by the enforcers.
- **Actions.** Where a material misstatement in the financial information is detected the Securities Market Agency should take appropriate actions to achieve an appropriate disclosure and where relevant, public correction of the misstatement (in line with the requirements of IFRS). Non-material departures from the reporting framework will not normally trigger public correction even though they normally deserve an action as well (e.g., statement from the FSA conveyed to the infringer). Actions should be effective, timely enacted and proportional to the impact of the detected infringement.
- **Reporting.** The Securities Market Agency should periodically report to the public on their activities providing at least information on the enforcement policies adopted and decisions taken in individual cases including accounting and disclosure matters.

²³ Standard No. 1 on "Financial Information – Enforcement of Standards on Financial Information in Europe" issued on March 12, 2003, and No. 2 on "Financial Information – Co-ordination of Enforcement Activities" issued on April 22, 2004 by CESR.

51. **Enhance academic education, as well as training.** The IFRS and ISA adoption reinforces the need for updated curricula and well-prepared instructors. At the university level, an advisory board should review and update the accounting curriculum in order to incorporate all international accounting and auditing standards and practical-oriented teaching at the undergraduate university level. The ethical dimensions of business management, corporate finance, and accounting and auditing should be taught with case studies in undergraduate programs. Particular attention needs to be given to increasing students' critical thinking skills. To enhance the capacity of faculty to teach accounting and auditing courses with international components, universities may need to retool and expand the scope of existing programs.

52. **Enhance professional education, as well as training.** The IFRS and ISA adoption reinforces the need for related education and training for preparers, auditors, and regulators. With regard to regulators, the staffs of the Bank of Slovenia, the Insurance Supervision Agency and the Securities Market Agency should be provided meaningful theoretical and practical training in order to enforce accounting, financial reporting, and auditing standards. Training should encompass practical experience in the banking, insurance and securities market; with legal and compliance issues; and with accounting and auditing and financial issues.

Authorities' response to the assessment:

In the opinion of the Slovenian Institute of Auditors, the existing public oversight of the auditing profession, via the Auditing Council of the Slovenian Institute of Auditors, meets the criteria of public oversight set forth in Article 31 of the proposed 8th EU Company Law Directive:

The Auditing Council must have ultimate responsibility for the oversight of:

- a) the approval and registration of statutory auditors and audit firms,
- b) the adoption of standards on ethics, and internal quality control of audit firms and auditing, and
- c) continuous education, quality assurance, and investigative and disciplinary systems.

The Auditing Council has the right, where necessary, to conduct investigations of statutory auditors and audit firms, and to take appropriate disciplinary action.

Although the system of public oversight is funded by the audit firms, it is secure and free from any possible undue influence by statutory auditors or audit firms. Audit firms pay the Institute a supervision fee, which is set by the Institute, to cover supervision costs. The sum of the fees to be paid by all audit firms for an individual year should not exceed the actual costs of supervision for that year. If an audit firm fails to pay the fee within the period stipulated by the Institute, the Institute shall request payment from the audit firm by way of a written decision.

Although the Auditing Council currently has a majority of non-practitioners, this occurs solely by chance. Hence, a formal, statutory requirement for the Auditing Council to have a majority of non-practitioners is necessary. Furthermore, the system of public oversight should be made more transparent, and annual work programs and activity reports should be published. Hence, these two issues must be addressed so that the Auditing Council can fully meet the requirements set forth in the proposed 8th EU Company Law Directive.