

REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)

Serbia and Montenegro – Republic of Serbia

ACCOUNTING AND AUDITING

June 24, 2005

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Executive Summary

As work on the economics of information—the role of information in a well-functioning economy—demonstrates, enhancing the reliability and availability of financial reporting is conducive to economic growth and mitigates the risk of financial system instability. In this context, this Report provides an assessment of accounting and auditing standards and practices in Serbia. It uses International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA) as benchmarks, and draws on good practices in the field of accounting and audit regulation to assess the quality of financial information and make policy recommendations.

This report also has regard to the European Union (EU) law (also known as the *acquis communautaire*). The relevance of the *acquis communautaire* for Serbia is twofold. First, and perhaps most importantly, because it represents a high-quality model for the regulation of accounting and auditing, which may be applied to countries of differing characteristics. Second, the adoption of the *acquis communautaire*, as it pertains to accounting and auditing, would be instrumental to further Serbia's keen interest in deepening economic association with the EU.

This Report highlights significant weaknesses in the quality of financial information, which are detrimental to sustainable economic growth and may allow systemic risks to perpetuate. Regarding the former, inadequate financial reporting by state-owned enterprises hinders the Government's and the Privatization Agency's monitoring of those enterprises and its ability to steer the privatization process. It may also distort fair competition between the private sector and those State-owned enterprises. As regards the latter, lack of consolidated financial reporting helps perpetuate systemic risks that go unmonitored in an environment with significant cross-ownership between banks and insurance companies, banks and the real sector, and emerging major financial and industrial groups.

This report was prepared by a team from the World Bank on the basis of the findings from a diagnostic review carried out in Serbia in 2004. The staff team was led by Frédéric Gielen (ECSPS) and included Michael Gascoyne (ECSPS), David Nagy (ECSPS), as well as Neil Wallace (Consultant). The review was conducted through a participatory process involving various stakeholders and led by the country authorities.

Enhancing the Statutory Framework based on the Acquis Communautaire and International Standards

This Report highlights significant shortcomings in the legal and regulatory framework and stresses that addressing those should be a priority for Serbia in order to create a robust legal foundation for the provision of reliable financial information to market participants. Three pervasive issues stand out:

- *Inadequate financial reporting requirements.* Groups present consolidated financial statements, which—in several cases—are not prepared in accordance with IFRS. Also, financial reporting requirements applicable to banks, insurance companies and listed companies—while much more stringent than for other companies, do not provide users of financial information, including regulators, with financial information reliable enough for decision-making purposes.
- *Inappropriate scope of application of IFRS.* The Serbian Accounting and Auditing Law (A&A Law) of 2002 requires IFRS for all enterprises, from sole proprietorships to large enterprises, as from their 2004 financial statements, and for financial institutions as from their 2003 financial statements. This requirement poses several significant problems. First, IFRS were designed for large enterprises, and since compliance with IFRS entails substantial investments, including training and information technology, there is a risk that the costs of applying IFRS in small enterprises may outweigh the benefits. Second, some important accounting and auditing concepts have not yet been consistently mastered by all segments of the accounting profession; managers and regulators. Consequently, the culture of compliance will suffer, even among companies that should be expected to have the resources to comply (e.g. banks, large state-owned enterprises). Experience shows that there is greater success when the application of IFRS is confined to *public interest entities* only, and when limited resources are focused on ensuring compliance by these entities.
- *Tensions between regulatory/statistical reporting and general purpose financial information.* The legal requirement for companies to apply IFRS may conflict with other legal requirements. An example of this is the overly formulaic approach to loan classification and provisioning required under the standard forms which may result in an under or overstatement of the allowance for loan losses as compared to (i) IFRS and, in some instances, (ii) actual economic losses, with a likely consequential impact on capital adequacy, taxation (the allowance is tax deductible), and interest rate pricing. Also, the regulations of the National Bank of Serbia require that the financial statements of financial institutions comply with a fixed format presentation (‘standard forms’) in their general-purpose financial statements, which makes it extremely difficult, if not impossible, to comply with IFRS.

A proposal for a new Accounting and Auditing Law is currently under discussion, which makes this a propitious moment for the ROSC assessment. The Serbian government has a window of opportunity to align its statutory framework with international good practice, including the *acquis communautaire*, and address some additional pressing areas of concern, including the revamping of the institutional framework governing the audit profession.

Enforcing Financial Reporting Requirements

This Report demonstrates that legal requirements and competence alone are not enough – the commitment to deploy such competence is also essential. Market forces provide certain positive incentives to comply with high standards, but experience in Serbia (and developed economies) suggests that countervailing disincentives operate to discourage such compliance. More emphasis should be placed on the deterrent incentives of robust monitoring and enforcement regimes to achieve a full and balanced combination of capacity and incentives

In this context, the Report suggests that a three-pillar approach to enforcement would be beneficial:

- Revamp the corporate governance framework to ensure that Directors of a company are responsible for the probity of financial statements both *de jure* (recently introduced by the new Law on Business Companies) and *de facto*.
- Establish a well governed audit profession responsible for reporting on compliance with accounting standards where audits are mandated by law. The Report recommends the establishment of a ‘Chamber of Auditors,’ constituted as a professional body enjoying delegated regulatory authority but subject to a public oversight system. The Chamber should regulate ‘external auditors,’ i.e. those responsible for financial statement audit in accordance with ‘full ISA.’ Among other things, the Chamber should exercise quality assurance over the public interest activities of its members, by way of monitoring of their work; exercise disciplinary authority over its members; and issue audit licenses to both individuals and audit firms. This should be coupled with an oversight system for the audit profession to ensure that quality assurance is, in fact and appearance, an exercise with sufficient public integrity. This report also recommends that policymakers leverage—where possible—the existing structures within the accountancy profession. However, leveraging these structures should not jeopardize the underlying principle whereby members of the Chamber should only include duly qualified statutory auditors, i.e. professionals who meet stringent educational and professional experience requirements.
- Establish institutionalized financial information enforcement mechanisms. The repeated instances of non-compliance with existing accounting requirements identified in this Report suggest that there could be unrevealed discrepancies in financial statements with possible significant impact, which may not have been adequately flagged by the auditors of these financial statements. This Report recommends that regulators play a more active role in the enforcement of accounting standards in the general-purpose financial statements of *public interest entities*. While the Report recognizes that this may not be achievable in the immediate future, it points to actions that could be readily addressed by regulators that would have a positive effect on strengthening enforcement. For example, in many instances, regulators should refuse to accept disclaimers or qualified audit reports. Rather, such qualifications should immediately trigger on-site examinations and/or restatements of the financial statements.

Enhancing Academic Education and Professional Training, and “Retooling” Accountants

In addition to these improvements, there is a strong need to improve the capacity of the accounting and audit profession in order to enhance the quality of financial statements and of

statutory audit, and promote public trust. The genuine understanding and adoption of these new accounting and auditing requirements requires related education and training for preparers, auditors, and regulators. This Report makes a number of recommendations to address capacity issues.

From Diagnostic to Reform

The recommendations of this Report are mutually supportive in some obvious ways and require a holistic, multi-disciplinary approach to implementation. Also, the Report only sketches the policy recommendations to enhance the quality of corporate financial reporting. The Report strongly recommends that Serbia establishes a multidisciplinary National Steering Committee (NSC) for accounting and auditing reform to advise policymakers, regulators, and other stakeholders regarding the implementation of the recommendations. Based on the successful experience of other countries the Report recommends that the NSC develops a Country Strategy and a detailed Country Action Plan (CAP) to enhance the quality and availability of financial reporting in Serbia. The Strategy should be endorsed by the Government and the CAP should be implemented under the coordination of the NSC and with assistance from international development partners. In this context, the Report recommends that the members of the NSC should include senior representatives of stakeholder institutions with adequate support staff to follow through on the substantial reform agenda ahead.

I. INTRODUCTION

1. The Republic of Serbia (henceforth “Serbia”) is part of the Union of Serbia and Montenegro. This assessment of accounting and auditing practices pertains only to Serbia. The assessment 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 ROSC Accounting and Auditing assessment focuses on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting and involves a review of both mandatory requirements and actual practice. It uses International Financial Reporting Standards (IFRS)¹ and International Standards on Auditing (ISA)² as benchmarks and draws on international experience and good practices in the field of accounting and audit regulation. The assessment also has regard to the relevant requirements of European Union (EU) law (also known as the *acquis communautaire*).

2. Since restarting its transition to a market economy in late-2000, Serbia has made good initial progress across a range of areas. This progress began from a very difficult starting point, which reflected the legacy of a decade of isolation, conflict, and poor economic management. Strong stabilization efforts coupled with greatly increased capital inflows have supported a reduction of end-of-period inflation from 115 percent in 2000 to 7.8 percent at end-2003. However, due to some one-off shocks, i.e. higher oil prices, introduction of the value added tax (VAT), etc, inflation increased through May 2005, when it reached 17.5 percent.³ Initial reforms of the trade regime, ownership relations, the business environment, the financial sector, and the labor market have also begun to lay the foundations for more rapid growth. As a result, Serbia’s previously dysfunctional banks are beginning to attract new deposits and make new loans.

3. Serbia has approximately 600 state-owned enterprises and 1,500 socially-owned enterprises. In 2002, these accounted for approximately 50 percent of gross domestic product (GDP). While no reliable contemporary data are available, their current share of GDP is now assumed to be much lower. The Serbian Privatization Agency lists over 1,800 of these enterprises slated for sale either through auction (smaller companies) or through a tender process. There are also approximately 100,000 small and medium enterprises (SMEs), which have a growing shock-absorbing function in the economy.

4. The Serbian financial sector is small and bank-dominated. There are 46 banks registered in Serbia with total assets of CSD 458 billion (equivalent to approximately US\$7.3 billion),⁴ which represent more than 90 percent of the financial system with total assets of 38.5 percent of

¹ Within this report, IFRS refer to both International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board and the Standards issued by the Board of the International Accounting Standards Committee, and each applicable Interpretation of the International Financial Reporting Interpretations Committee.

² International Standards on Auditing are the standards issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants.

³ Serbia was a hyperinflationary economy for many years. Such an environment required specific accounting techniques, since reporting the operating results and financial position of an enterprise in local currency without restatement would not be useful. Money loses purchasing power at such a rate that comparison of amounts from transactions and other events that have occurred at different times, even within the same accounting period, would be misleading.

⁴ Value based on the rate applicable in April 2005: Serbian Dinar (CSD) 63.05 = US\$1.00.

GDP, as of the end of 2004. Non-bank credit institutions play a small role in the system (with total assets of 0.2 percent of GDP) while leasing assets account for 2.1 percent of GDP. The insurance sector is largely comprised of non-life activities, which, nominally, at least, have survived the 1990s, with a penetration (premium/GDP) of 2.1 percent. This is, in fact, overstated, as a proportion of premium receivables are not recoverable. Life insurance and voluntary pensions business is growing rapidly from a negligible level. Capital and money markets, in addition to the equity market, are quite small.

5. Relations between the Union of Serbia and Montenegro and the EU are anchored in the EU's Stabilization and Association process (SAP). The SAP supports the development and preparations for future EU membership by combining three main instruments: the Stabilization and Association Agreements (SAA), autonomous trade measures, and substantial financial assistance through the CARDS program. The SAAs are tools that provide, much as the Europe Agreements did for the candidate countries in Central and Eastern Europe, the formal mechanisms and agreed benchmarks that allow the EU to work with each country to bring them closer to EU standards. The SAAs focus on respect for key democratic principles and the core elements of the EU single market. Through a free trade area with the EU and the associated disciplines (competition and state aid rules, intellectual property, etc) and benefits (e.g. rights of establishment), the SAAs allow the economies of the region to begin to integrate with the EU. In addition, SAAs contain provisions on the phased approximation of legislation to the *acquis communautaire*, including its effective implementation. Particular emphasis is placed on legislation that is closely linked to the functioning of the EU's single market, including financial reporting requirements.

6. On April 12, 2005, the European Commission confirmed sufficient progress to open negotiations on an SAA. Negotiations may be opened in late 2005 or early 2006. This will mark an important milestone in the process of Serbia and Montenegro's closer integration with the EU, which is intended to lead towards their eventual EU membership. Hence, the relevance of the *acquis communautaire* for Serbia is twofold. First, and perhaps most importantly, because it represents a high-quality model for the regulation of accounting and auditing, which may be applied to countries of differing characteristics. Second, the adoption of the *acquis communautaire*, as it pertains to accounting and auditing, would be instrumental to further Serbia's keen interest in deepening economic association with the EU.

II. INSTITUTIONAL FRAMEWORK

A. Statutory Framework

7. **The Law on Business Companies, effective January 1, 2004, regulates business activities in Serbia.** The Law recognizes four types of companies: *general partnerships*, *limited liability partnerships*, *limited liability companies*, and *joint stock companies*.⁵

- *General partnership*, a partnership set up under an agreement between two or more legal entities and/or natural persons undertaking to conduct a certain business under a common

⁵ The remaining part of this report addresses primarily financial reporting by *limited liability companies* and *joint stock companies*.

name, and who are jointly and severally liable for the firm's commitments. As of end-2004, there were 9,915 general partnerships (up from 2,974 in 2003) playing a small economic role.

- *Limited partnerships*, a partnership formed under an agreement between two or more parties for the purpose of conducting business under a joint name, of which at least one—the general partner—is jointly and severally liable for the partnership's commitment, and at least one person—the limited partner—is limited to his contracted investment. As of end-2004, there were 1,411 limited liability partnerships playing a small economic role.
- *Limited liability companies*, the shares of which are not publicly tradable. Limited liability companies have a limited number of shareholders (not more than 100), and a minimum capital of EUR 500. Limited liability companies generally have a unitary board (board of directors). As of end-2004, there were 60,211 limited liability companies.
- *Joint stock companies*, the shares of which may be publicly tradable. Joint stock companies generally have a large number of owners and a minimum capital of EUR 10,000. Joint stock companies, including banks, insurance companies,⁶ have a two-tier management structure (board of directors and supervisory board). As of end-2004, there were 2,675 joint stock companies.

8. **Serbia's laws and regulations do not provide a robust statutory framework in the area of accounting and auditing.** Consequently, much needs to be done to enhance Serbia's laws and regulations. Policymakers are already using the *acquis communautaire* as a benchmark in modernizing the legal and regulatory framework.^{7, 8} The remainder of this Section highlights the areas where Serbia would benefit from increased harmonization with the *acquis communautaire* both from a political (relationship with the EU) and economic (financial stability and positive impact on growth) point of view. This Report recognizes that Serbia will also have to address significant issues in the design and strengthening of suitable institutions to implement and enforce the *acquis* requirements.

9. **The Law on Business Companies requires shareholders to approve the financial statements of a company and establishes that members of the board of directors are collectively responsible for the probity of legal entity and consolidated financial statements.**⁹ Article 29 of the Law on Accounting and Auditing (2002) states that a body of the legal entity, as provided by the articles of incorporation or bylaws shall be responsible for the financial statements. In practice, financial statements are signed by both the Chief Accountant

⁶ Refer to Article 41 of the Banking Law and Article 47 of the Insurance Law.

⁷ For a presentation of the portions of the *acquis communautaire* relevant to accounting and audit regulation, refer to: *Corporate Sector Accounting and Auditing within the Acquis Communautaire*, Gielen, Hirata Barros, World Bank, February 2005.

⁸ The MoF is in the process of preparing a new draft law on accounting and auditing to rectify shortcomings in the Accounting and Auditing Law (2002). As it is still in a draft stage, this report only draws on the existing Law (2002).

⁹ This report outlines the legal principles applicable with regard to directors' liability and does not attempt to give anything more than an introduction to the issues. This report is not meant to be an exhaustive rendition of the law nor is it legal advice to those reading it.

and the Managing Director of the enterprise. The Law requires that the ‘Chief Accountant’ be a ‘qualified person’ but there is no legally recognized system in place to authorize accountants.

10. **The Accounting and Auditing Law (2002) establishes that legal entities can be fined from CSD 100,000 to 3 million (equivalent to approximately US\$1,600 to 47,000) for a series of detailed commercial offenses associated with financial reporting.** The ‘responsible person of the legal entity can also be fined CSD 5,000 to 150,000 (equivalent to approximately US\$80 to 2,400) for the associated commercial offenses. The ROSC team is not aware of any instances where such fines were levied.

11. **Financial reporting by Serbian enterprises is governed by various laws and regulations.** The application of corporate financial reporting requirements to different enterprises is summarized in Table 1, which should be read in conjunction in paragraphs 12 to 18 below:

Financial Statements Entities	Legal Entity Financial Statements	Consolidated Financial Statements
Large legal entities (Paragraphs 12 to 15)	IFRS and standard forms or grids set out by the Ministry of Finance (MoF)	Refer to Paragraph 15
<u>Including:</u> Banks (Paragraph 16)	IFRS and standard forms or grids set out by the National Bank of Serbia (NBS)	
Insurance companies (Paragraph 17)	IFRS and standard forms or grids set out by the NBS	
Listed companies (Paragraph 18)	IFRS and standard forms or grids set out by the MoF	
Medium legal entities (Paragraphs 12 to 15)	IFRS and standard forms or grids set out by the MoF	
Small legal entities (Paragraphs 12 to 15)	IFRS and standard forms or grids set out by the MoF (balance sheet and income statement only)	

Table 1: Financial Reporting by Serbian Enterprises (from January 1, 2004)

12. **The Accounting and Auditing Law (2002) applies to all enterprises, cooperatives, banks, insurance companies, and other financial organizations, as well as sole proprietorships. It requires that all enterprises from the largest listed companies to the smallest unincorporated proprietorships must comply with IFRS from 2004.** This requirement seems not only unnecessarily onerous for SMEs and sole proprietorships but inapplicable since IFRS is not designed for the smaller company and certainly not for sole proprietorships. Such a requirement casts doubt on the overall wisdom of the Law itself. Full IFRS are not appropriate for use by all reporting entities; they should be used unchanged as the

standards for *public interest entities*,¹⁰ and separate standards should apply to other entities. The use of IFRS as that single set of requirements in other jurisdictions has frequently led to unintended negative consequences, hindering successful implementation, as full IFRS are not appropriate for SMEs. In such cases, the necessary capacity for proper application was often not in place, costs of compliance were disproportionate, and enforcement bodies either did not exist or were unable to cope with the volume of work required. Over time, the culture of compliance suffered, even among those companies that should be expected to have the resources to comply. Experience shows that success is greater when the application of IFRS is confined to public interest entities only, and when limited resources are focused on ensuring compliance by these entities.¹¹

13. The Ministry of Finance (MoF) and the National Bank of Serbia (NBS) develop standard forms for the preparation of financial statements of enterprises, and banks and insurance companies, respectively, which do not conform to IFRS. In accordance with article 28 of the Accounting and Auditing Law (2002), the MoF and the NBS develop standard forms to ensure a consistent flow of information and statistical processing (refer to paragraph 43 below). IFRS are standards for the preparation of general-purpose financial statements, aimed at meeting the needs of a wide range of users, but predicated on the assumption that placing primary emphasis on the needs of shareholders will result in measurement, recognition and disclosure requirements that also meet the needs of other users. However, significant other users of financial statements need not necessarily share this view, and where they have the power and authority to do so, experience shows that they frequently impose different special-purpose financial reporting obligations designed to meet their specific needs (e.g. reporting for taxation purposes, reporting for statistical purposes, or reporting for prudential and supervisory purposes). Serbia, not unlike many other countries, does not appear to have successfully managed this interface between general-purpose and regulatory/statistical reporting. In Serbia, rules designed for the latter have an impact on the former, whereby enterprises and banks are required to use standard forms in the preparation of their financial statements, which do not allow compliance with IFRS in terms of recognition, measurement, and presentation (refer to Section III).

14. The Accounting and Auditing Law (2002) distinguishes between large, medium and small businesses and provides the relevant threshold details, however Serbia could make more use of these thresholds to exempt more SMEs from an excessive accounting burden, as allowed under the Fourth and Seventh EU Company Law Directives. If on the date of preparation of its financial statements, a legal entity meet at least two of the following criteria, it is considered large:

- average number of employees > 250;
- net annual turnover > 10 million EUR; and
- total balance sheet > 5 million EUR.

Likewise, if an entity meets at a least two of the following criteria, it is considered small:

¹⁰ Within this report, public interest entities are those in which the general public has an interest by virtue of the nature of their business, their size, their number of employees, or their range of stakeholders. Examples include banks, insurance companies, investment funds, pension funds, listed companies, and large enterprises, including large state-owned enterprises.

¹¹ Refer to *Implementation of International Accounting and Auditing Standards: Lessons Learned from the World Bank's Accounting and Auditing ROSC Program*, Hegarty, Gielen, Hirata Barros, World Bank September 2004.

- average number of employees < 50;
- net turnover of ranging < 2.5 million EUR; and
- total balance sheet < 1 million EUR.

All other entities are considered medium. As of end-2004, there were approximately 100,000 small enterprises (including unincorporated sole proprietorships), 2,200 medium enterprises, and 977 large enterprises.

15. The Accounting and Auditing Law (2002) requires groups to present consolidated financial statements. However, observers indicated that this requirement is only rarely complied with, and that the method of consolidation is understood as a basic addition of the balances of the parent and subsidiaries.

16. Banks are supervised by the National Bank of Serbia and are subject to the Law on Banks and Other Financial Organizations (2003) (henceforth, the 'Banking Law'), which sets additional reporting requirements for banks. Banks were required to prepare IFRS financial statements starting from the year ended December 31, 2003. However, the limited nature of the standard forms or grids required to be filed with the NBS Solvency Center does not enable compliance with 'full IFRS' or the EU Banking Accounts Directive. Article 77 of the Banking Law requires that the audit of banks' annual financial statement should be carried out in line with the Law (2002) and ISA.

17. Insurance companies are supervised by the National Bank of Serbia and are subject to the Insurance Law (2004), which sets additional reporting requirements for insurance companies. The limited nature of the standard forms or grids required to be filed with the NBS Solvency Center does not enable compliance with 'full IFRS' or the EU Insurance Accounts Directive. The chart of accounts and standard accounts grid for the insurance companies is prescribed by the NBS.

18. Listed companies must be registered with the Securities Market Regulator (SMR). They are supervised by the SMR and are subject to the Law on the Market of Securities and Other Financial Instruments (2003) (henceforth, the 'Securities Law'). The Belgrade Stock Exchange has three listing segments: List A, List B and the over-the-counter (OTC) market. The Securities Law imposes a series of filing requirements, in addition to those for non-listed companies, on companies listed on Lists A and B. Currently, however, there are no companies listed on these segments. All companies are traded on the OTC market, which does not mandate additional filing requirements. There are 466 companies, representing a market capitalization of approximately US\$6.9 billion, traded on the OTC market. The inexistence of companies on Lists A and B may be due, in part, to regulatory arbitrage, i.e. evasion of the additional regulations imposed by Lists A and B through trading on the less regulated OTC market. However, the ROSC team has not been able to confirm this hypothesis.

19. The scope of statutory audit requirements may be too broad considering the stage of development of the audit profession. In accordance with the Accounting and Auditing Law (2002) the audit of financial statements is compulsory for large and medium-sized legal entities, as well as the issuers selling their long-term securities by public offering. However, the transitional provisions in the Law (2002) exempted medium-sized enterprises from statutory

audits for the year ended December 31, 2003. Based on the definition in paragraph 14 above, from 2004, approximately 3,200 out of 103,000 active Serbian enterprises and other regulated entities (e.g. banks, insurance companies, investment and pension funds, etc.) should be audited by 160 certified auditors operating in 32 registered audit firms (refer to paragraph 28 below).¹²

20. **The Accounting and Auditing Law (2002) regulates the auditing profession in Serbia. It requires that statutory audits be carried out in accordance with the Law (2002), ISA, and the International Federation of Accountants (IFAC) Code of Ethics for Professional Accountants.** The Law requires auditors to opine on whether the financial statements present fairly, in all material respects, the financial position of the company, and the results of its operations in accordance with IFRS. The discrepancies between the standard forms required by the MoF or the NBS and IFRS may require statutory auditors to systematically qualify their opinion or, worse, express an adverse opinion on the financial statements. This unintended consequence would certainly further damage the credibility of financial reporting in Serbia and should therefore be rectified.

21. **According to the Accounting and Auditing Law (2002),¹³ the ‘competent body’ appoints the statutory auditor annually.** Such a competent body is set forth in the relevant supplementary legislation. For example, the Law on Business Companies sets forth that for limited liability companies, the members’ meeting is responsible for appointing the statutory auditor (Art. 137) and for joint-stock companies, shareholders are responsible (Art. 290) for the appointment. Unlike in certain EU Member States, the Law (2002) does not include any termination mechanisms that could provide additional safeguards to auditor’s independence. Hence, a statutory auditor may resign or be dismissed to avoid an audit qualification. The Law (2002) provides for the rotation of an audit firm every five years in medium enterprises and every three years in large enterprises.^{14, 15} The Law (2002) does not require the statutory auditors to attend the annual shareholders’ meeting or be available for questions by the shareholders.

22. **The Accounting and Auditing Law (2002) sets out additional legal requirements concerning audits of banks and insurance companies but these requirements are inconsistent (refer to Table 2 below).** In addition, there is no significant involvement of the statutory auditor in the prudential control of banks or insurance companies. Statutory auditors are also not required to report matters of urgent interest to the regulators. For example, the legislation does not require statutory auditors to report violations of laws or regulations and deficiencies, which might threaten the solvency of an insurance company.

¹² The Serbian Association of Accountants and Auditors or “SAAA” (refer to Paragraph 30) indicated that approximately 55 professionals among the above 160 obtained their qualification through the SAAA professional examination process. The ROSC team was unable to establish whether the other professionals among the above 160 were subjected to a professional examination.

¹³ See Article 33 of the Accounting and Auditing Law (2002).

¹⁴ Article 4 of the Law (2002) defines large legal entities as banks, other financial institutions, insurance companies, stock exchanges and stock brokers.

¹⁵ The audit firm rotation requirement in an environment such as Serbia’s, which has a limited audit firm base, may lead to the negative, unintended consequence of restricting a company’s ability to choose its external auditor. This problem would be even more acute in larger companies, which tend to use the local member firms of international audit networks.

Sector	Auditors appointed by shareholders	Inform regulator about appointment / resignation / termination of auditors	Approval of auditor by regulator	Regulator has an explicit right to request information from the auditor
Banks ¹⁶	✓	n/a	n/a	n/a
Insurance companies ¹⁷	n/a	✓	✓	✓

Table 2: Specific requirements relating to the audit of banks and insurance companies

23. There is a lack of consistency among the different laws and regulations regarding filing deadlines:

Fin. statements Legislation	(Unaudited) legal entity financial statements	(Unaudited) consolidated financial statements	Audited financial statements
Accounting and Auditing Law (2002)	Within <u>two</u> months of the year end to the NBS Solvency Center.	Not done in practice due to lack of standard forms (see paragraph 15)	Within <u>six</u> months of the year end to the NBS Solvency Center.
Banking Law (2003)	N/A	N/A	Within <u>six</u> months of the year end to the NBS Solvency Center (Article 36). Within <u>six and a half</u> months of the year end to the NBS and the MoF (Article 77).
Insurance Law (2004)	N/A	N/A	Within <u>four</u> months of the year end (Article 156).
Securities Law	Within <u>three</u> months of the year end to the Securities Commission (Article	Within <u>three</u> months of the year end to the Securities Commission (Article	Within <u>six and a half</u> months of the year end to the Securities Commission (Article

¹⁶ Refer to Article 43.9 of the Banking Law.

¹⁷ Refer to Article 197 of the Insurance Law. There is no requirement relating to the resignation or termination of the auditor.

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Table 3: Deadlines for filing of financial statements in Serbia

24. **The Accounting and Auditing Law (2002) requires all enterprises to file legal entity financial statements with the NBS Solvency Center by end-February, and consolidated financial statements by end-March. Different deadlines for parent companies to file legal entity and consolidated financial statements conflicts with IAS 27, which effectively requires the parent company to present both financial statements contemporaneously.** In addition, the audit report does not need to be submitted until the end of June. These “inconsistent” requirements make the processing of audit adjustments highly problematic. It is unclear whether the approved financial statements can be different from the statements provided to the NBS Solvency Center four months earlier, and what the procedure is for accepting adjustments arising from the audit and thus changing statements already provided to the NBS Solvency Center. The Ministry of Finance highlighted that the February deadline above has been set to meet the needs of Statistics and Tax authorities while the June deadline has been set to meet the needs of other users of Financial Statements who rely on audited Financial Statements.

25. **Financial statements lodged with the NBS Solvency Center are publicly available.** The Solvency Center controls the submission of financial statements and the relevant audit reports through the use of a “base number” allocated by the Commercial Court on registration of the business. The ROSC team was able to obtain a sample of statements for purposes of the review (refer to Section III of this report) but it was obvious from conversation with staff that this service is not frequently used by the Serbian business community or members of the public. This may be due to the relatively high cost in some instances (Euro 25 per individual set of company financial statements) of the search, the perceived low quality of financial statements, the lack of electronically available financial information, and failure by large and medium enterprises to file their audited financial statements.¹⁸

B. The Profession

26. **The statutory and institutional frameworks required to underpin the development of a quality audit profession have yet to be established.**¹⁹ The Federal Ministry of Finance (in the former Federal Republic of Yugoslavia) governed the approval of programs for professional certificates, the organization of exams and issue of certificates, and also maintained a register of audit firms and certified auditors. The former Federal Republic of Yugoslavia was dissolved as of April 1, 2003. Subsequently, the MoF of the Republic of Serbia formally took over the above-

¹⁸ While all 977 large enterprises submitted their financial statements to the Solvency Center only approximately 600 submitted audit reports. Approximately 50 of these reports were qualified. Those enterprises, which failed to submit audit reports, received a written warning but no further action was pursued by the Solvency Center. Of the 103,000 total enterprises, 96,000 submitted financial statements to the Solvency Centre with the remaining 7,000 being reported to the Prosecutor by the Solvency Center. New shorter return forms have been developed for non-bank companies for their 2004 financial statements submission to the Solvency Center, which depart from IFRS.

¹⁹ This A&A ROSC report focuses primarily on statutory audit and less so on the accountancy profession at large.

mentioned duties in respect of individuals and firms registered in Serbia. However, no professional certificates have been issued or foreign professional certificates validated.

27. **The Accounting and Auditing Law (2002) required the Government to establish an Accounting and Auditing Commission (henceforth, the ‘A&A Commission’)** to oversee the profession. The A&A Commission was to be responsible for the following:

- monitoring (i) the development of the profession, and (ii) the implementation of IFRS and ISA;
- adopting national accounting and auditing standards;
- supervising the quality of the work performed by the relevant professional associations; and
- granting and revoking licenses and certificates.

However, the A&A Commission was never established.²⁰ As a result, the four levels of qualification for professional accountants set forth in the Law—accountant, independent accountant, certified accountant, and certified auditor—have not been applied in practice and currently have no meaning.²¹ According to the Law (2002), an accountant may only maintain the financial records for small entities, whereas independent accountants and certified accountants may maintain the financial records for any enterprise. Further, under the supervision of a certified auditor, a certified accountant may participate in the performance of statutory audit. In addition, the Law requires all three levels of accountants to pass examinations in accordance with ‘national standards,’ which were also supposed to have been established by the A&A Commission.

28. **The situation where the demand is greater than the supply of professionally qualified auditors is likely to persist for a number of years unless policymakers take action on both the supply and demand side.** The Accounting and Auditing Law (2002) grandfathered existing certified auditors but had envisaged that they should be required to complete A&A Commission examinations in IFRS within three years of the law becoming effective, i.e. by December 31, 2005, to retain their license. While the objective to ‘retool’ grandfathered auditors was laudable,²² the A&A Commission was not established and the examination never organized. Serbian observers are uncertain about the legal status of these grandfathered auditors after January 1, 2006. The Ministry of Finance indicated that there were approximately 160 registered individuals gathered in 32 audit firms, including many retirees and individuals working in academia. The current lack of auditors—which is likely to increase given the demographics of

²⁰ Despite this, the Government of the Republic of Serbia established a Commission to supervise the implementation of IFRS, ISA and professional rules on April 8, 2003 (Official Gazette RS no 37), and appointed its Chairman and five members. The Commission’s authority was amended so that it is not authorized to set national accounting and auditing standards or grant and revoke licenses/certificates. The Commission is effectively an advisory body to the Serbian Ministry of Finance. The new draft law on accounting and auditing is expected to address the licensing of statutory auditors.

²¹ The SAAA indicated that it is registered with the State Register and the Commercial Courts as a provider of education and professional examination relating to these four titles.

²² The exams were required because auditors included on the current Ministry of Finance list have not all been formally trained or examined in modern international principles and practice. There does not appear to be any final decision at present on how to take this issue forward and observers raised doubts as to the skills and experience of many currently registered auditors.

registered auditors—is reinforced by the lack of new entrants and the scope of statutory audit requirements described in paragraph 19 above.

29. **The Accounting and Auditing Law (2002) does not allow statutory auditors to work as sole practitioners, which further exacerbates the problem of a lack of auditors and does not comply with the *acquis communautaire*.**²³ Article 31 of the Law requires that the audits of financial statements for medium legal entities may only be conducted by auditing firms employing at least one person holding the title of certified auditor, and three persons holding the title of certified accountant, and for large legal entities, firms employing at least three persons holding the title of certified auditor. The shortage of registered (certified) auditors and their high average age is such that many firms fear that the death or retirement of one of their auditors may result in the forced closure of their Serbian statutory audit activity or merger with another firm.

30. **Until 1998, article 66 of the Accounting Law (1993) had conferred considerable legal powers to the Serbian Association of Accountants and Auditors or “SAAA”.** The SAAA had the authority to:

- appoint the examination board and conduct the examinations for the award of professional titles;
- issue the certificates of professional titles; and
- keep the register of professional titles.

The Accounting and Auditing Law (2002) does not confer any such legal powers to the SAAA and it operates solely as a voluntary professional institute. This has not met with the approval of the SAAA, which is striving to regain its self-regulatory powers.

31. **Many audit reports are issued by persons not included on Ministry of Finance’s list of registered auditors.** The SAAA is offering training courses, setting examinations and issuing “licenses.” Given the hiatus in the issuing of licenses by the MoF (or the Commission) it is difficult to argue that this is an unreasonable response from the local profession.

32. **The SAAA is publicly supportive of IFAC Statements of Membership Obligation (SMOs). However, since the IFAC Compliance Program is still in its infancy, compliance with the SMOs has yet to be assessed.** Founded in 1955, with a membership of around 30,000 individual auditors and accountants, the SAAA is a full member of IFAC.²⁴ It has a committee structure as set forward in the Organizational Structure in Figure 1 below. Although the SAAA is

²³ The *acquis communautaire* provides that statutory audits shall be carried out by statutory auditors or audit firms. A “statutory auditor” is defined as a natural person who is approved in accordance with the provisions of the Eighth EU Company Law Directive to carry out statutory audits. On March 16, 2004, the European Commission issued a Proposal for a Directive of the European Parliament and Council on statutory audits of annual accounts and consolidated annual accounts (the “new Eighth Directive”). The proposal would supersede the Eighth EU Company Law Directive 84/253/EEC, of April 10, 1984, on the approval of persons responsible for carrying out statutory audits of accounting documents (the “old Eighth Directive”). Both the old and the new Eighth Directives require that duly approved natural persons be authorized to carry out an audit. Therefore, requiring natural persons to form an audit firm to carry out a statutory audit is a departure from the *acquis communautaire*.

²⁴ The SAAA memberships includes (i) “fully qualified members,” i.e. 55 certified public accountants and 7,784 chartered accountants, and (ii) “candidates awaiting full qualification,” i.e. 7,727 independent accounting technicians and 14,813 accounting technicians.

publicly supportive of IFAC SMOs, IFAC's Compliance Program will not be distributing self-assessment questionnaires to evaluate compliance with the IFAC SMOs to its Member Bodies until later this year. IFAC SMOs are designed to provide clear benchmarks to current and potential IFAC member organizations to assist them in ensuring high quality performance by accountants worldwide. SMOs cover quality assurance, education standards, auditing standards, ethics, investigation and discipline, etc.²⁵ For additional information, refer to <http://www.ifac.org/Compliance/index.php>.

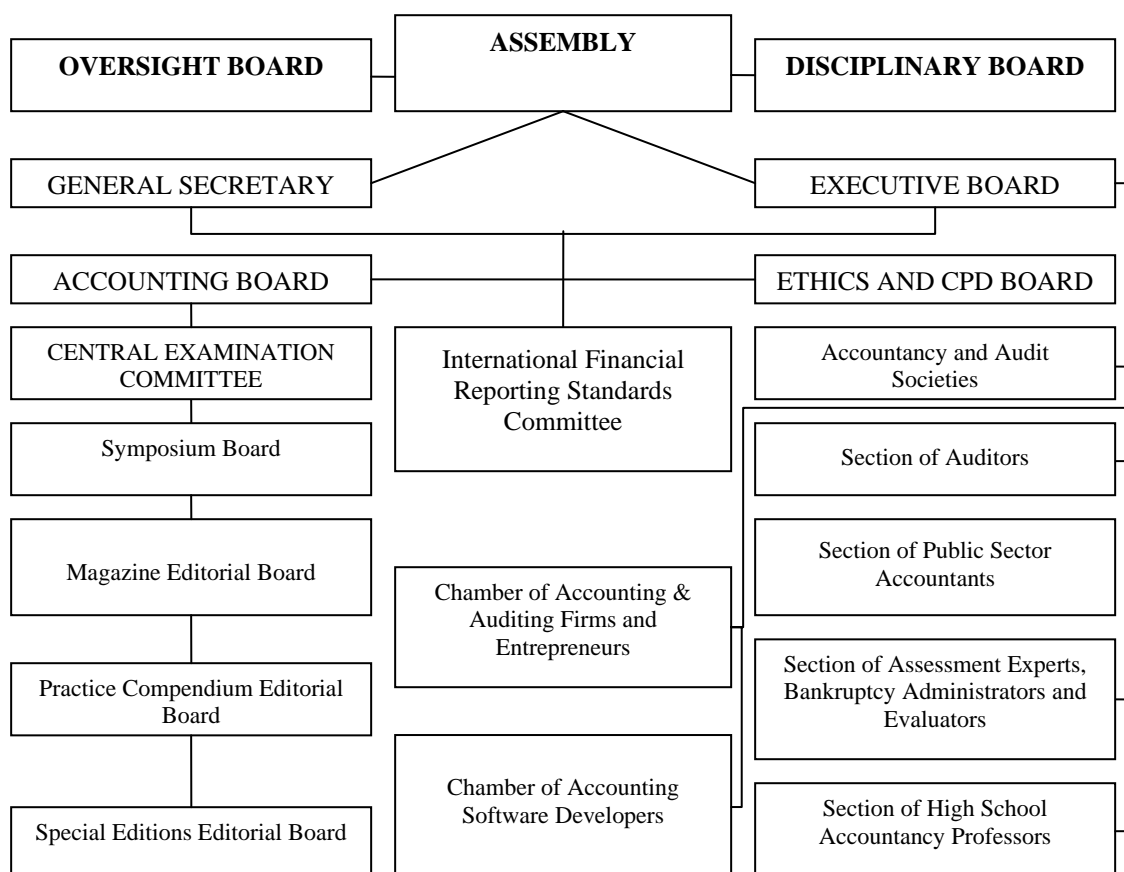


Figure 1: Organizational Chart of Serbian Association of Accountants and Auditors²⁶

33. **Existing accounting and auditing regulatory arrangements place an excessive burden on the Ministry of Finance.** The prevailing arrangements under the Accounting and Auditing Law (2002), supplemented by the Decision of the Government of the Republic of Serbia to form the Accounting and Auditing Commission, transferred accounting and audit regulation authority from the SAAA to the Commission and the Ministry of Finance. It is widely recognized, internationally, that the current lack of confidence in the audit function is partly based on a public perception that a self-regulating profession runs a serious risk of conflicts of

²⁵ For additional information, refer to <http://www.ifac.org/Compliance/index.php>.

²⁶ Source: Serbian Association of Accountants and Auditors, 2005.

interests in dealing with its shortcomings. Reducing the self-regulatory prerogatives that the SAAA derived from the Accounting Law (1993) is therefore consistent with internationally accepted practices. This is particularly important in Serbia where the broad membership of the SAAA (30,000) does raise doubts as to the fulfillment of the conditions required for membership. However, while a credible element of public oversight over the audit profession is crucial to enhance public trust in the audit function, and while there is no blueprint on how to set up an effective public oversight mechanism, it is generally acknowledged that leveraging the profession and all stakeholders (e.g., the regulatory community, users of financial statements, etc.) should be the preferred approach in regulating accounting and auditing.²⁷ In addition, in our view, public oversight should not be interpreted as oversight solely by the Ministry of Finance. Rather, the system of public oversight should be governed by non-practitioners who are knowledgeable in the areas relevant to statutory audit. These non-practitioners may be specialists who have never have been linked with the audit profession or former practitioners who have left the profession.

34. The Accounting and Auditing Law (2002) does not include any requirements for any form of audit practice quality review, which is detrimental to the credibility of the audit profession and therefore of published audited financial statements. This does not conform to IFAC SMOs and the *acquis communautaire*, which require such quality review schemes to ensure that auditors are working to required standards of quality. The SAAA does have its own limited practice review system for its members. The SAAA Commission for Supervision and Quality Control was set up in 2003 and commenced work in 2004. However, it does not include a strict enforcement mechanism.²⁸

35. Although required by the Accounting and Auditing Law (2002), there is no system in place to ensure that auditors comply with the IFAC Code of Ethics for Professional Accountants. Amongst auditors with whom the ROSC team met there is a varying degree of awareness of the actual content of the ethical standards. Without any method of ensuring auditors are working in compliance with ethical standards the public cannot be assured of the Serbian auditors' genuine commitment and adherence to internationally agreed standards of integrity and objectivity, professional competence and due care, confidentiality, professional behavior and technical standards. Public confidence in both the quality of auditing is suffering as a result.

36. Existing legal, civil and criminal provisions relating to auditors' liability and disciplinary sanctions do not appear to establish a strong deterrent. The main issues concerning the current Serbian legislation regarding auditors' liability and disciplinary sanctions include the following:²⁹

²⁷ The Serbian Ministry of Finance is in the process of preparing a new draft law on accounting and auditing. The ROSC team has provided several comments on the draft law to the Ministry of Finance to align the draft law with the recommendations included in this report

²⁸ The SAAA indicated that the Association is unable to implement strict enforcement and disciplinary mechanisms without adequate legislative support.

²⁹ This report outlines the legal principles applicable to auditors' liability and does not attempt to give anything more than an introduction to the issues. This report is not meant to be an exhaustive rendition of the law nor is it legal advice to those reading it.

- Although the Accounting and Auditing Law (2002) provides for fines ranging from CSD 100,000 to 3 million (equivalent to approximately US\$1,600 to 47,000) against audit firms that fail to conduct audits in accordance with the Law,³⁰ there is no evidence that an audit firm has ever been prosecuted under these provisions. In addition, there may be cases where such amounts are too low to be an effective deterrent.
- The Civil Code provides for a civil liability mechanism and article 33 of the Law (2002) requires audit firms to maintain professional indemnity insurance. A minimum coverage amount has not been established. The ROSC team is unaware of any cases of civil action against an auditor for negligent work.
- In the absence of an effective regulator, no disciplinary sanction is imposed.

37. **There is a lack of transparency of audit firms and their networks, including the relationship between the local firms and their international networks, which could impede adequate monitoring of the profession.** The ROSC team was unable to obtain documented information regarding the internal quality assurance arrangements of audit firms, including the size of the audit firm, the owners and management members of the audit firm, the network's membership or the basis for partner remuneration, and the number of clients in sectors of the economy. Transparency should be a natural requirement for audit firms, which fundamentally operate to ensure transparent financial reporting by companies. In addition, the absence of such information has implications for effectively regulating and monitoring the audit profession.

C. Professional Education and Training

38. **The University of Belgrade Faculty of Economics, has developed courses that include, to some extent, the IFAC Code of Ethics for Professional Accountants, ISA and IFRS.** Although there is no specific degree in accounting, these are included as electives within the Bachelors Degree in Economics. Without further detailed analysis, it is impossible to assess the breadth and quality of coverage of the above topics but senior lecturers have highlighted the lack of lecturers, lack of physical resources and excessive class sizes as factors preventing the proper development and delivery of courses. In addition, they have pointed to the difficulty of translating IFRS, ISA and relevant textbooks into Serbian. Most of the student textbooks and course material are written by the faculty and most are not up-to-date with the latest accounting and auditing standards. Examinations are a combination of written papers and oral presentations.

39. **Given the current problematic situation in Serbia, there is no professional qualification that can lead to registered accountant or auditor status.** Generally, local member firms of international audit firm networks do not send their students to study with the SAAA but instead encourage their students to study for the United Kingdom ACCA qualification. The ACCA program is now taught locally but since it is reasonably new, few graduates have yet completed the system. Generally speaking, young graduates employed by smaller audit and accounting firms have a problem with the funding of their education and training. Few of the small audit firms in Serbia are willing to fund the training of graduates for two key reasons. First, they fear that upon professional qualification, the person would leave the firm thereby leading to loss of the firm's investment in human resources. Second, the

³⁰ See Article 37.15 of the Accounting and Auditing Law (2002).

qualification would not lead to any formal registered status as accountant or auditor and would therefore not provide any immediate tangible benefit to the firm.

40. **The criteria set out in the Accounting and Auditing Law (2002) for the approval of statutory auditors conform to the existing Eighth EU Company Law Directive, which sets forth the minimum requirements for statutory auditors in the EU.** Article 32 of the Law (2002) defines the minimum requirements for future registered auditors. The intention was to require that the auditor should be both an independent and qualified person and be responsible for conducting the audit, preparation of the auditor's report and the opinion expressed in the report. The Law (2002) sets out that the certificate issued to the certified auditor may be obtained by a person who:

- holds the title of certified accountant;
- has a university degree;
- has two years of auditing experience; and
- meets the requirements to acquire the certificate as provided by the national standard specifying the requirements of professional development and titles to be acquired by accountants and auditors.³¹

However, without the A&A Commission these requirements cannot be enforced and the list of registered auditors remains temporarily closed.

41. **The SAAA has its own professional syllabus, which is partly based on the ACCA program and purports to comply in all respects with IFAC International Educational Standards.** Currently, the SAAA has approximately 1,200 students, with training being carried out at all 30 branches of the SAAA, using internal and external instructors. There are three levels within the syllabus: (i) Accounting Technician, (ii) Chartered Certified Accountant, and (iii) Chartered Public Accountant, requiring the passing of all 14 papers plus six years relevant experience.³² Completion of this third stage means that the SAAA will class the person as an auditor. However, as discussed in paragraph 31 above, this has no status in law.

42. **There is no Continuing Professional Development (CPD) requirement included within the Accounting and Auditing Law (2002).** Given the lack of enforced CPD, doubt must therefore be cast as to how technically up to date the auditors included on the Ministry of Finance list actually are. This is another area where lack of control is damaging public confidence in the quality of Serbian auditing and financial reporting. The internal SAAA requirement on CPD is for practitioners to receive 30 hours per year (40 hours starting 2006). This training is required to be documented and forwarded to the SAAA.

D. Setting Accounting and Auditing Standards

43. **Required accounting and audit standards are detailed in the Accounting and Auditing Law (2002).** ISA was required for all audits of 2003 financial statements. IFRS was required from 2003 for banks only but all other enterprises and sole proprietorships were

³¹ In addition, the person must not have been convicted of criminal charges disqualifying him/her for tasks performed in the area of auditing.

³² University graduates having a relevant degree can obtain a maximum of five waivers from such papers.

required to introduce IFRS from 2004. However, article 28 of the Law requires the Ministry of Finance to develop standard forms for the presentation of financial statements of enterprises, sole proprietorships, insurance companies, etc. to ensure a consistent flow of information and statistical processing. Article 28 also requires the National Bank of Serbia to develop such standard forms for the presentation of bank financial statements. As analyzed in Section III below, based on a sample of financial statements reviewed by the ROSC team, these standard forms may hinder compliance with ‘full IFRS.’

44. **The SAAA has translated the 2004 version of IFRS and ISA (the 2005 versions should be published in the coming months).** The SAAA has permission from both IFAC and the International Accounting Standards Committee Foundation (IASCF), to translate future ISA and IFRS into Serbian.

E. Enforcing Accounting and Auditing Standards

45. **There is no effective mechanism to enforce the requirements of the Accounting and Auditing Law (2002).** Given the resource constraints of the Solvency Center, it is unlikely that any serious breach of IFRS could be detected by this department of the National Bank of Serbia. Complete reliance is placed on the statutory auditor identifying any material breach of IFRS. There does appear to be a culture of making the annual returns to the Solvency Center, but it is the quality and not quantity of the returns that is in doubt.

46. **As detailed in the Banking, Insurance and Securities Laws, the National Bank of Serbia and the Securities Market Regulator require the regular submission of financial data and audited annual financial reports.** However, given their resource constraints, and despite their best efforts, they cannot fully review the returns submitted particularly in terms of their compliance with IFRS. The Banking, Insurance and Securities Laws all detail criminal and economic offenses associated with misleading reporting:

- The Banking Law states that a bank shall be fined CSD 600,000 to 3 million (equivalent to approximately US\$9,600 to 47,000) for economic offences associated with the failure to lodge financial statements and failure to provide the auditor with all required information.
- The Insurance Law states that authorized persons who submit to the National Bank of Serbia false information shall be sentenced for a criminal offence to three months to five years of imprisonment. The Insurance Law also states that certified auditors who, against the provisions of this Law, give a false opinion, shall be sentenced for a criminal offence to one to three years of imprisonment.
- The Securities Law (article 245) details that intent to mislead an investor in the organized market of securities can lead to a punishment by a fine or imprisonment of up to three years.

The ROSC team is not aware of any sanctions having been imposed in this specific area since the introduction of the new laws.

47. **There is no formal or effective mechanism for independent external review of the quality assurance arrangements in audit firms.** Although the SAAA has a limited form of

practice review, the SAAA has no legal regulatory powers and very importantly, only approximately 100 of the 160 auditors authorized by the MoF are members of the SAAA. The ROSC team noted there has never been a public announcement of a breach of ethical principles governing auditors' professional responsibilities.³³

III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

48. **The Accounting and Auditing Law (2002) states that IFRS should be adopted by all enterprises.** Consequently, there should not be any 'standards gap' as far as accounting standards are concerned. The Law sets out that the 'federal authority in charge of finance' shall authorize legal entities to translate and publish IFRS.

49. **Based on a review of the Accounting and Auditing Law (2002) and the standard form set out by the Ministry of Finance, there are fundamental differences between reporting requirements and "full IFRS" pertaining to medium-sized and large enterprises in the real sector.** Legal financial reporting requirements are considered 'fulfilled' by the completion and submission of the above mentioned standard forms or grids, which include account numbers, issued by the MoF. The 2003 form was 20 pages long (non-IFRS). This has the following consequences:

- January 1, 2004 was used as the transition date to IFRS in preparing 2004 financial statements. This is not in accordance with IFRS 1, *First-time Adoption of International Financial Reporting Standards*, which would have required that January 1, 2003 be used as the transition date if preparing IFRS financial statements for the first time as at December 31, 2004.
- Presentation of the comparative financial information was not required. Such practice is not in accordance with the requirements of IAS 1, *Presentation of Financial Statements*, which would require comparative financial information to be presented.
- Presentation and disclosure is defined and limited to the options available.
- Narrative disclosure is not accommodated.
- There is no consolidated information.
- Exchange rate gains or losses from the translation of long-term loans denominated in foreign currency (receivables/payables) at year-end are deferred in the balance sheet. Such treatment is not consistent with IFRS.
- The standard accounts grid does not comply with IFRS in certain respects:
 - Off-balance sheet assets and liabilities are presented within the balance sheet. Such items do not meet the definition of either an asset or a liability under IFRS.
 - If total shareholders' equity is less than zero, then an asset is recorded in the balance sheet of the company at year-end under the caption "Loss exceeding

³³ The SAAA indicated that the Association took disciplinary sanctions against 363 and 167 professionals in 2003 and 2004, respectively. As noted in footnote 28, the Association asserted that monitoring and enforcement are hindered by lack of adequate legislative requirements. The proposal for a new Accounting and Auditing Law, which is currently under discussion, should address this issue.

equity,” such that total shareholders equity then equals zero. This asset does not meet the definition of an asset under IFRS.

50. Based on a review of the Accounting and Auditing Law (2002) and the standard form set out by the NBS, there are significant differences between actual reporting requirements and ‘full IFRS’ pertaining to banks. Selected differences include the following:

- *Legal financial reporting requirements are considered “fulfilled” by the completion and submission of the above mentioned standard forms or grids, which include account numbers, issued by the NBS.* The standard ‘IFRS’ document for banks in 2003 was nine pages long. In general, the existence of these forms makes it difficult for banks to adapt to the spirit of IFRS and encourages a bureaucratic, ‘form over substance’ attitude to financial reporting.

IFRS requires an entity, which purports to comply with IFRS, to make an explicit and unreserved statement of such compliance in the notes to its financial statements. In order to affirm IFRS compliance, a company must comply 100 percent with all the recognition, measurement and disclosure provisions of the standards and interpretations; if a company complies with 99 percent of IFRS requirements, it cannot affirm compliance with IFRS. It is for this reason that IAS 1, *Presentation of Financial Statements*, states that ‘financial statements shall not be described as complying with IFRS unless they comply with all the requirements of IFRS’. The International Accounting Standards Board has therefore established unambiguously the principle that full application of its standards and related interpretations is a necessary prerequisite for an entity to assert that its financial statements comply with IFRS.

- *Consolidated financial statements were not presented, which has an adverse impact on the transparency of financial reporting.* Banks are required to publish legal entity financial statements rather than consolidated financial statements. The lack of consolidated financial statements prevents the users of bank financial statements from assessing their actual financial position and performance.
- *Formulaic approach to the determination of the allowance for loan losses.* The NBS has issued a regulation, which requires banks to classify loans, placements, guarantees, and other on and off-balance sheet exposures into categories A, B, C, D, and E, in accordance with the evaluation of their collectibility, which is largely assessed based on the number of days the payments are in arrears.³⁴ The allowance for loan losses is determined based on a provisioning matrix that specifies fixed provisioning rates for each category (2 percent for A,³⁵ 5 percent for B, 25 percent for C, 50 percent for D, and 100% for E). While it might be relevant for prudential purposes, the regulation’s formulaic approach differs significantly from the method to calculate the recoverable amount of originated loans and receivables under IAS 39. IAS 39 requires impairment or bad debt losses to be calculated as the difference between the asset’s carrying amount and the present value of expected future cash flows discounted at the financial instrument’s original effective interest rate. The

³⁴ The regulation mentions other criteria, including the financial standing of counterparties, and the quality of the security obtained as collateral. However, the overwhelming criterion remains the borrower’s payment record.

³⁵ The amount relating the general loan amount for category A is presented as a reserve in equity.

allowance for loan losses under IFRS may therefore differ significantly from that under the NBS regulation. In addition, an overly formulaic approach to loan classification and provisioning may result in an under/overstatement of actual economic losses, with consequential impact on capital adequacy, taxation, and interest rate pricing.³⁶

- *Lack of usage of the effective interest rate method on valuation.* Loans and other financial instruments originated by banks and financial instruments held to maturity are usually stated in the balance sheet at the principal amounts outstanding from customers, less any allowances for impairment. This policy departs from IAS 39, *Financial Instruments: Recognition and Measurement*, which requires the valuation of these types of financial instruments at their amortized cost, using the effective interest rate method.
- *Missing appropriation of fee and commission income from loan origination fees.* Banks in Serbia generally account for loan origination fees on a cash basis and do not follow the guidance of IAS 18, *Revenue*, with regard to the appropriation of loan origination fees. Financial service fees should be distinguished between fees that are an integral part of a financial instrument's effective interest rate, fees that are earned as services are provided, and fees that are earned on the execution of a significant act. Loan origination fees charged by banks are an integral part of establishing a loan. These fees should be deferred and recognized as an adjustment to the effective yield.

51. **The Accounting and Auditing Law (2002) required banks to introduce IFRS for the financial year ended December 31, 2003, and other enterprises to do so for the financial year ended December 31, 2004.** However, since 2004 financial statements were not available at the time this report was drafted; this report refers to 2003 financial statements in its analysis of accounting practices. This means that for enterprises, the financial statements should have been prepared according to the previous Accounting Law (1993);³⁷ for banks, the 2003 financial statements should have been prepared under IFRS.

52. **The ROSC team made assessments of the compliance gap sampling 20 sets of non-bank financial statements for the year ended December 31, 2003, which had been lodged with the NBS Solvency Center.** The 2003 financial statements for all entities other than banks were prepared using the contents of the Accounting Law (1993). This review provided an insight into the general culture of compliance within financial reporting in Serbia:³⁸

- Financial statements are required to be submitted on the standard NBS Solvency Center Financial Statements return form, which details a pre-printed list of Serbian

³⁶ The ROSC team recommends that additional research be conducted to assess if current loan loss provisioning has had unintended effects, as a ROSC assessment is unable to reach conclusive findings on this matter.

³⁷ The 1993 law set forth detailed descriptions of required accounting treatments, which were effectively used as the 'Serbian accounting standards.' It was then repealed by the Law on Accounting and Auditing (2002), which is currently in force.

³⁸ 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 Serbian 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 may not reflect systemic problems that would apply to companies in general.

chart of account codes. The layout of the chart of account codes was detailed in the supplement to the Accounting Law (1993). They cover the Balance Sheet, the Income Statement and the Cash Flow Statement together with supplementary notes. Companies were required to follow a strict format for the submission of their financial statements. All of the 20 financial statements which the ROSC team reviewed were detailed on the required standard Solvency Center forms and complied with the layout for the Balance Sheet, Income Statement and Cash Flow Statement. However two of the supplementary notes for “Equipment Depreciation” and “Inventory Data” were not completed in any of the 20 financial statements.

- The audit reports reviewed do not necessarily relate to the specific financial statements lodged at the Solvency Center because of the four month timing difference between the submission of financial statements and submission of audit reports. However, five of the 20 audit reports were qualified and in three others the auditors did not express an opinion. Recurring issues, which led to a qualified audit opinion or a disclaimer of opinion included:
 - Inventory balances at the balance sheet date could not be confirmed,
 - Contingent liabilities were not estimated and included in the balance sheet,
 - Lack of appropriate evidence available to substantiate balances, and overstatement and understatement of other balances for various reasons.

The financial statements examined were all generally compliant with the Accounting Law (1993) in terms of presentation. However the Law did not require many of the disclosures required under IFRS such as the disclosure of related party transactions. The high incidence of audit reports including qualifications and disclaimers of opinion suggests that there is considerable opportunity for improvement in terms of the quality of financial reporting. The movement to IFRS will undoubtedly create significant additional problems for accountants and auditors.

53. The ROSC team made assessments of the compliance gap, sampling 10 sets of bank financial statements for the year ended December 31, 2003, which had been lodged with the NBS Solvency Center. Where submitted, the relevant audit reports were also obtained. Some banks also produce non-statutory ‘Annual Reports’ (glossies) and where possible these too were obtained from the bank itself. The 2003 financial statements for all banks were prepared using the contents of the Accounting and Auditing Law (2002). This review provided an insight into the compliance issues to be expected across Serbia from 2004. However the ROSC team expects the problem to be even further exacerbated in the non-bank financial sector and the real sector as compared to the banking sector:³⁹

- *Bank financial statements for 2003, required to be produced for the first time in accordance with IFRS and filed with the NBS Solvency Center, did not include comparative figures for 2002.* This was primarily due to the obvious technical difficulties of converting 2002 figures from the local standards to IFRS. This effectively meant that the financial statements did not comply with the fundamental requirement of IFRS that comparative information be shown.⁴⁰ Audit reports were

³⁹ See footnote 38.

⁴⁰ The IASB has reiterated this requirement in IFRS 1, *First-time Adoption of International Financial Reporting Standards*, which requires that an entity’s first IFRS financial statements include at least one year of

generally not qualified as the auditors referred to the fact the statements had been prepared in accordance with Serbian legislation and not the full requirements of IFRS. The same first time adoption dispensation regarding comparatives has been granted for non-banks in 2004. As with the previous year, this announcement was issued in the Official Gazette.

- *Within the banking and auditing community, there was general understanding that the 2003 bank financial statements were not prepared in accordance with IFRS. Financial statements included in the glossies were more comprehensive and detailed, including comparatives and notes, than those submitted to the NBS Solvency Center. For such statements, the ‘Independent Auditor’s Report’ referred to the fact that the financial statements had been prepared ‘in accordance with the accounting regulations prevailing in Serbia.’ When obtained, in the more comprehensive annual reports the ROSC team also noted that the ‘Basis for Preparation’ notes included extensive details of where the accounting policies differed from IFRS. These included the note that “Given that the NBS requires the filing of legal entity financial statements, the bank did not consolidate its financial statements in accordance with IAS 27, Consolidated and Separate Financial Statements, and IAS 28, Investments in Associates.”*

54. **As mentioned, the Accounting Law (1993) was applied up to the end of 2003 by all companies other than banks.** The “underlying assumptions” of IFRS for use in the preparation of financial statements, as set out in the IASB framework, are the “Accrual Basis” and “Going Concern” basis. These concepts were also identified in the Accounting Law (1993). However, although the former law specified these principles, these concepts have not been fully understood or applied in practice. Due to the unstable nature of the economy in Serbia, in accounting terms with true application of IFRS, many companies would likely not be considered to be a “going concern” at the date of preparation of the financial statements. However the ROSC team noted that due consideration of this fact is not made in financial statement preparation, and the going concern basis may often be used when not appropriate. Various parties who took part in the ROSC review also highlighted the fact that items of income and expense are recognized only when the transaction is complete and the physical evidence verifying this is obtained. Therefore the “accruals” concept is not widely applied in Serbia. It is unlikely, when all companies prepare financial statements which are supposed to be in accordance with IFRS, that they will correctly understand how to apply this principle.

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

55. **The Accounting and Auditing Law (2002) states that statutory audits should conducted be in accordance with ISA.** Consequently, there should not be any ‘standards gap’ as far as auditing standards are concerned. However, there seems to be considerable uncertainty

comparative information under IFRS. The IASB provided some limited exemption from the requirement to restate comparative information for IAS 39, *Financial Instruments: Recognition and Measurement*, and IFRS 4, *Insurance Contracts*, only.

as to whether statutory auditors currently comply with all current ISA and the latest Code of Ethics for Professional Accountants.⁴¹

56. The list of registered auditors held by the Ministry of Finance is effectively temporarily closed. Added to this fact, the auditors on the list held by the MoF have never been required to undergo an ISA/IFRS professional training program. Additionally, there is no Continuing Professional Development requirement in Serbia,⁴² which raises doubts as to the quality and technical knowledge of registered auditors and their ability to carry out an ISA/IFRS compliant audit. There must also be doubts as to their knowledge and genuine application of the IFAC Code of Ethics for Professional Accountants.

57. The financial reporting environment within which auditors operate makes it difficult for them genuinely to apply ISA making the processing of audit adjustments difficult. Financial statements are submitted two months after the year end. Audit reports should then be submitted to the Solvency Center four months after the submission of the financial statements. This creates huge difficulties when attempting to raise and process audit adjustments to accounts that have already been lodged. Auditors may be subject to unavoidable pressures from clients when attempting to process adjustments.

58. Few shareholders, directors, or members of management understand the purpose of an audit, and this makes it difficult to obtain appropriate audit evidence. Audit is perceived as a legal obligation and no benefit is expected to be obtained. There is an obvious need for more education of investors, directors, management and staff.

59. The audit firms visited as part of this review were certainly familiar with the existence of the IFAC Code of Ethics for Professional Accountants and ISA, which have long been available in Serbia. Most, but not all, of the auditors with whom the ROSC team spoke have a good working knowledge of ISA and certainly knew how to carry out basic substantive audit procedures. However, on-site reviews of some firms' audit working papers (where firms agreed to grant access to selected files) revealed a number of weaknesses in audit methodology (e.g. an overall risk assessment is not made, controls are not documented, no account of materiality is considered in determining the scope of the audit procedures). Many small audit firms lack the resources to ensure they obtain fully adequate annual training in critical new technical issues with IFRS and ISA. Few of the small audit firms have access to modern audit tool kits such as audit manuals or audit packs, making it much more difficult for them genuinely to apply ISA. Few firms appear to be familiar with the detailed contents of the Code of Ethics for Professional Accountants. The majority of firms will accept any audit client other than one in which the firm or its owners have a direct financial interest.

V. PERCEPTIONS ON THE QUALITY OF FINANCIAL REPORTING

⁴¹ For example, the ROSC team obtained the engagement letter relating to the statutory audit of the 2004 IFRS financial statements of an enterprise. The engagement letter stated that the audit would be conducted in accordance with International Standards on Auditing set out by the International Auditing Practices Committee of IFAC in 1996.

⁴² However, as noted in Paragraph 42, members of the SAAA are subject to a Continuing Professional Development requirement.

60. **Evidence suggests that financial reporting in Serbia is tax driven, and that financial information is perceived as generally not reliable.** The preparation of annual financial statements is perceived as being tax driven with the annual statutory audit and the filing at the Solvency Center regarded as bureaucratic requirements. There is little demand for financial statements from other users due to the undeveloped capital market and the lack of trust placed in published financial reports. The majority of corporate lending is based on the borrower's capacity to post collateral rather than its ability to service the debt, i.e. financial analysis supporting lending decisions is limited and as such, audited corporate financial statements figure little in the lending process. Little value appears to be placed on the statutory annual audit.

VI. POLICY RECOMMENDATIONS

61. **The recommendations of this Report are mutually supportive in some obvious ways.** For example, superb accounting standards are jeopardized at the outset if people do not understand how to translate the standards into a journal entry. Without attempting to provide a detailed tactical design for reform, this ROSC accounting and auditing report sketches the policy recommendations to enhance the quality of corporate financial reporting. The report recommends the formation of a National Steering Committee (NSC)⁴³ for accounting and auditing reform to advise policymakers, regulators, and other stakeholders regarding the implementation of the recommendations. Based on the successful experience of other countries the report recommends that the NSC develops a Country Strategy and a detailed Country Action Plan (CAP) to enhance the quality and availability of financial reporting in Serbia. The Strategy should be endorsed by the Government and the CAP should be implemented under the coordination of the NSC and with assistance from international development partners. These reforms should contribute to promoting private sector growth and reducing financial system instability, through:

- Strengthening Serbia's financial architecture and reducing the risk of financial market crises and their associated negative economic impacts, including through increased transparency about the financial condition and performance of *public interest entities*;
- Contributing to foreign direct and portfolio investment
- Helping mobilize domestic savings;
- Facilitating the access of smaller-scale corporate borrowers, including small and medium enterprises, to credit from the formal financial sector by shifting gradually

⁴³ Best practice examples of NSCs in other jurisdictions involve multi-disciplinary groups gathering policymakers, regulators and the private sector. Past experience has demonstrated that the chairmanship of the NSC is critical for the success of the program. A Government official of high rank, such as from the Ministry of Finance, typically chairs the NSC. Members may include representatives from the Ministry of Finance, securities market regulator, banking regulator, the regulator of insurance companies and other non-banking financial institutions, higher education institutions, professional accounting and auditing bodies, auditing firms, preparers, and institutional investors. The ROSC team recommends that the criteria for membership include demonstrated technical competency and knowledge of financial accounting and reporting; strong analytical skills; excellent communication skills; judicious decision making abilities; awareness of the financial reporting environment; and commitment to accounting reform and the public interests.

- from collateral-based lending decisions to lending decisions which are based on the financial performance of the prospective borrower;
- Improving the assessment and collection of taxes on corporate profits;
- Allowing investors to evaluate corporate prospects and make informed investment and voting decisions, which will result in a lower cost of capital and a better allocation of resources;
- Allowing shareholders and the public at large to assess management performance, thus influencing its behavior (financial reporting is also a building block of a market-based monitoring of companies); and
- Assisting policymakers in adopting and implementing the relevant portions of the *acquis communautaire*.

62. The policy recommendations set forth in this report are predicated on the notion that achieving a high-quality regulatory and institutional framework for accounting and auditing is a long-term objective for Serbia. Using the *acquis communautaire* as a benchmark would be a logical way for Serbia to achieve this greater goal, as the existence of a well-developed *acquis* in the area of accounting and auditing regulation facilitates the choice of appropriate models to follow. In addition, considering the EU's economic importance for Serbia, in terms of trade and investment flows, it would be appropriate to harmonize business practices, including in the area of accounting and auditing, with those of the EU. As set forth in this report, constructing a high-quality regulatory and institutional framework for accounting and auditing requires extensive reforms to Serbia's legal framework, institutions, and accounting profession, as well as changes in its accounting, auditing and business culture. The ROSC team believes that simply enumerating an exhaustive list of all policy recommendations that should be carried out to achieve Serbia's long-term objective would not be particularly constructive. Policies should not be developed and enacted without giving due regard to a country's ability to carry out such policies (both in terms of capacity and resources); a relatively lenient rule that is robustly and consistently enforced is preferable to a good, rigorous one that is unenforceable, as the lenient rule can be progressively made more rigorous as circumstances allow. As a result, the ROSC team has decided to set forth policy recommendations that, while challenging, can be carried out in the short to medium term.

63. **Serbia should amend its laws and regulations in a manner that is consistent with the *acquis communautaire*, which will provide a sound underpinning for reliable corporate financial reporting.** This will require the National Steering Committee to make a number of choices (e.g. regarding thresholds) to effectively adapt the *acquis* to the Serbian environment. The amendments should be in line with the relevant EU Company Law Directives (Fourth, Seventh, Eighth, Banking, Insurance) and should take due account of Regulation 1606/2002 on the use of IFRS, as well as the portions of other EU requirements that are important for accounting and auditing (First Directive, Transparency Directive, etc.). A summary of the relevant *acquis* is available from the World Bank⁴⁴ and is complemented by the GDLN Advanced Program in Accounting and Auditing Regulation,⁴⁵ a web-based distance-learning program in which leading international experts in specific accounting and auditing topics share

⁴⁴ See footnote 7.

⁴⁵ For more information on GDLN, please see: www.worldbank.org/eca/aa.

their expertise with policymakers, regulators and civil servants in 14 participating countries/entities, including Serbia. The National Steering Committee and relevant stakeholders should draw on these tools in their policy debate to devise a regulatory framework that is adapted to the country. Specific recommendations regarding the required amendments to the statutory framework are given below⁴⁶:

- ***Application of IFRS by public interest entities but not SMEs:*** The *acquis communautaire* requires IFRS for the consolidated financial statements of listed companies. The ROSC team recommends that Serbia go further than that which is required under the *acquis*—yet take a few steps back from that which is currently required under the Accounting and Auditing Law (2002)—to require the application of IFRS for the consolidated financial statements of all *public interest entities*⁴⁷ (as compared to listed companies only under EU Regulation 1606/2002). Three criteria can be used to define such entities: (a) having securities listed, including on the OTC market; (b) the nature of the business (for example, banks and insurance companies);⁴⁸ and (c) the size of the business (exceeds thresholds regarding total assets, annual sales or number of people employed).⁴⁹ The ROSC team recommended that both small and medium-sized enterprises should not be obliged to apply IFRS, but the new Accounting and Auditing law published on July 2, 2006 in the Official Gazette no. 46/06, exempts only small enterprises (as defined in the law) from applying IFRS.
- ***Alignment of the new Accounting and Auditing Law with the requirements of the Fourth and Seventh EU Company Law Directives.*** Particular attention should be given to ensuring that the new Law, as well as Ministry of Finance and National Bank of Serbia rules, incorporate the requirement for groups to present consolidated financial statements, as per the Seventh Directive. In addition, full advantage should be taken of the exemptions allowed for SMEs under these Directives so that such companies are not faced with overly onerous accounting and financial reporting requirements. In setting exemptions, Serbia should ensure that the thresholds are consistent with the needs of the country.⁵⁰ Finally, inconsistent filing deadlines create a significant problem for the processing of audit adjustments; hence, financial statements subject to audit should only

⁴⁶ The Ministry of Finance is in the process of preparing a new Draft Law on Accounting and Auditing. The ROSC team hopes that the Ministry of Finance will have regard to these policy recommendations in revising the draft law.

⁴⁷ The corporate financial reporting and corporate governance structures of large SOEs are critical for ensuring their positive contribution to overall economic efficiency and competitiveness. As a result, significant state-owned companies should be considered *public interest entities* and required to follow IFRS.

⁴⁸ While this report generally recommends the application of IFRS, it is aware that its application in insurance companies is still under discussion. Given the scarce resources of Serbia, and since the IASB is still finalizing the specific standards on insurance accounting, this report recommends that Serbia observe what the EU decides before adopting full IFRS in the insurance industry. In the meantime, the Insurance Accounts Directive, and relevant adjustments made by individual Member States in its transposition, would be an appropriate benchmark.

⁴⁹ The National Steering Committee should recommend appropriate thresholds, based on (a) good international practice (e.g. those adopted by EU Member States) and (b) Serbia's ability to comply. This may mean that, in an effort to attain full compliance a priori, higher thresholds should be used, which may then be lowered as circumstances allow.

⁵⁰ In its Directives, the EU sets forth the maximum thresholds that should be applied; however, countries are expected to adjust these according to their own country circumstances. A threshold to define large companies that is relevant for a large Member State may be too high for a small Member State.

be filed together with the audit report.

- ***Harmonization of financial reporting requirements with the Company Law and Contract Law.*** New financial reporting requirements will also have an impact on the legal entity financial statements of a company. In this context, it is essential to study the effects of such a change vis-à-vis Company Law (e.g. distribution of dividends), Contract Law (e.g. loan covenants), and other relevant legislation.
- ***Elimination of conflicting or ambiguous financial reporting requirements.*** To ensure that there are no conflicting or ambiguous financial reporting requirements (see paragraph 13 above), the legal framework should be revised so that regulatory, statistical, and tax requirements do not affect IFRS-based general-purpose financial statements. If regulators need additional (unpublished) information for prudential supervision or statistical purposes, this should be done only by supplementing, not departing from, IFRS. This would have the added benefit of mobilizing regulators to assist in the enforcement of the requirements for general-purpose financial statements, since the regulators would have a keen interest in ensuring that the fundamental IFRS-based financial statements are correct (as their reports would be built on that foundation).
- ***Statutory audit requirements.*** The ROSC team recommended that when drafting the new Accounting and Audit Law, Serbia should exempt a number of limited liability companies from the statutory audit requirement so that only the large limited liability companies would be required to be audited. However the Accounting and Audit Law published on July 2 2006 in the Official Gazette no. 46/06, exempts only small limited liability companies, so that both medium-sized and large limited liability companies are required to be audited. The issue here is that attention must be given to the audit profession's capacity to conduct audits in these entities. In sum, the number of entities for which a statutory audit is required should be commensurate with the number of available auditors and consistent with the audit profession's current stage of development.
- ***Improve financial transparency requirements.*** With respect to non-listed limited liability companies, Serbia has the opportunity to significantly enhance compliance with disclosure requirements in line with the *acquis communautaire*, which requires a company to file its legal entity and consolidated financial statements, together with the auditor's report (where applicable) with a 'registrar' (in Serbia, the Solvency Center), which in turn is required to make the information publicly available. Seizing this opportunity will ultimately help to facilitate the granting and monitoring of credit to private sector business and will help to preserve fair competition. Improvement in this area might also help prevent companies from being used as vehicles for the perpetration of fraud or other criminal activity.
- ***Appointment and dismissal of statutory auditors.*** There is a need for legal provisions regarding the dismissal or resignation of a statutory auditor that provide adequate safeguards for his or her independence. For example, the new Accounting and Auditing Law could introduce the principle that the statutory auditor or audit firm can only be dismissed if there are proper grounds. In addition, the audited entity and auditor should be required to inform the relevant authority about the dismissal or resignation during the term of appointment and provide a justification.
- ***Serbia should adopt current ISA in their entirety.*** In adopting ISA, Serbia should have

regard to the requirements of the new Eighth EU Company Law Directive, when adopted by the EU Council and Parliament.

64. **In parallel with the improvements to the statutory framework, there is a strong need to invest in education to promote change in the business culture and improve the capacity of the accounting and audit profession, in order to enhance the quality of financial statements and of statutory audit, and to promote public trust.** It is essential to enhance the capacity of existing accountants as well as ensure the capacity of future accountants. For existing accountants, Serbia must introduce a legal requirement for continuing professional development in line with relevant IFAC standards as well as the requirements of the *acquis communautaire*. For future accountants, academic curricula must be updated, for example, to encompass IFRS; adequate training materials need to be developed; and professors must be retooled to adequately carry out the updated curricula. In addition, the following major issues should be addressed in order to effectively rectify the problems set forth in Sections II.B and II.C:

- **Shortage of registered auditors:** This issue requires urgent action. Although quality cannot be compromised, non-registered persons with the proper skills and experience may be offered an ‘accelerated route’ to qualification and registration. These could include persons with foreign accounting qualifications and persons with the appropriate number of years’ experience in the IFRS/ISA environment. A form of “grandfathering scheme” is also required to deal with the persons currently included on the list of registered auditors. Prior to this however, some formal assessment of their skills, experience and ability must be carried out. An option should also be granted for persons with appropriate foreign qualifications to become authorized, subject to local language competency testing.
- **Accountants in industry:** A program should be developed to specifically target the significant retooling needs of accountants in industry. A number of approaches exist, and can be broadly categorized as direct regulation or incentive-based policies, which are further described below. The “right” policy will likely draw upon both types to include a mix of positive incentives, compliance monitoring and punitive sanctions.
 - Direct regulation involves statutory requirements that are monitored and enforced by a regulatory body, and non-compliance is punishable by sanctions. It is important to note that in European Union Member States, there has been a clear trend away from direct regulation of accounting services, other than audit. With regard to the accounting profession, direct regulation generally takes one of the following three forms: required licensing, protection of an accounting title, or qualification for external accountants.
 - Incentive-based measures: While direct regulation mandates a certain type of behavior through rules, enforcement and sanctions, incentive-based measures encourage certain behaviors through rewards, which are usually market-based. The Government can play an active role in promoting the improvement of the quality of accounting profession through the use of incentives. These include an array of options, such as setting a good example through applying international good practice in accounting and auditing within state-owned enterprises, so that these may serve as a model for the rest of the corporate sector; and providing seed money or tax credits for the establishment of retooling programs of accountants in

enterprises.

- **Collective responsibility of board members.**⁵¹ The Law on Business Companies (2004) rightly introduced the collective responsibility of board members, in line with what the requirements of most EU Member States. In addition, investments in education will be required in order to achieve a behavioral change in the way directors approach financial reporting.

65. **While a more robust legal framework is being established, Serbia should modernize and strengthen its institutional framework so that once enacted, the new laws will have the necessary underpinnings to ensure the monitoring, supervision and enforcement of the new legal requirements.** This extends to all aspects of the institutional framework, including the banking and insurance supervisors, the securities market regulator, the courts, Ministry of Finance, national standard setters and the establishment of a quality assurance and public oversight system for the audit profession. The ROSC team recommends that the new institutional framework include the following:

- **Quality Assurance system for the audit profession,** in line with the requirements set forth in IFAC and SMOs and the *acquis communautaire*. The quality assurance system should ensure that auditors comply with applicable auditing and ethical standards, as well as independence requirements. It should also include periodic, in-depth quality reviews of audit firms and specific audit engagements, so that every firm or sole practitioner is subject to regular quality assurance. In addition, the quality assurance system should be used to identify weaknesses which should then be addressed by targeted continuing professional development.
- **Public oversight of the audit profession:** The quality assurance system should be supervised by a public oversight body consisting of a majority of non-practitioners. The purpose of the oversight system is to ensure that quality assurance is, in fact and appearance, an exercise with sufficient public integrity; it should also instill public confidence in the profession and demonstrate to regulators and the public the adequate discharge of self-regulating responsibilities. The public oversight system should ensure that all auditors are subject to a stringent quality assurance review and consistently applied disciplinary sanctions.

This calls for the establishment of a ‘Chamber of Auditors,’ constituted as a professional body enjoying delegated regulatory authority but subject to a public oversight system. The Chamber should regulate “external auditors,” i.e. those responsible for financial statement audit in accordance with “full ISA.” Among other things, the Chamber should exercise quality assurance over the public interest activities of its members, by way of monitoring of their work; exercise disciplinary authority over its members; and issue audit licenses to both individuals and audit

⁵¹ 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. On October 28, 2004, the European Commission proposed four key revisions of the Fourth and Seventh EU Company Law Directives to enhance confidence in corporate financial reporting. The first revision would establish that board members are collectively responsible for financial statements and key non-financial information.

firms. This should be coupled with an oversight system for the audit profession to ensure that quality assurance is, in fact and appearance, an exercise with sufficient public integrity. It should also instill public confidence in the profession and demonstrate to regulators and the public the adequate discharge of self-regulating responsibilities. The public oversight system should have the ultimate responsibility for the oversight of (i) the approval and registration of statutory auditors and audit firms, (ii) the adoption of standards on ethics, internal quality control of audit firms and auditing, and (iii) continuous education, quality assurance and investigative and disciplinary systems. In addition, the oversight system of public oversight should have the right, where necessary, to conduct investigations on statutory auditors and audit firms and to take appropriate action.

In this context, policymakers leverage—where possible—the existing structures within the accountancy profession. However, leveraging these structures should not jeopardize the underlying principle whereby members of the Chamber should only include duly qualified statutory auditors, i.e. professionals who meet stringent educational and professional experience requirements.

66. Enforcement of Accounting Standards. The recommendations above aim to strengthen two enforcement pillars: (a) preparers, through requiring collective responsibility of board members, retraining of accountants in industry, and enhancing academic education; and (b) auditors, through the adoption of ISA in line with the Eighth Directive, quality assurance system for the audit profession, and public oversight. However, it is essential to also address the third enforcement pillar: regulators. Different models exist, but this report recommends that regulators play an active role at least in the enforcement of accounting standards in the general-purpose financial statements of *public interest entities*. This may be done either through the establishment of a new body (e.g. such as the Financial Reporting Review Panel in the United Kingdom), or extending the role and capacity of existing regulators (National Bank of Serbia for banks and insurance companies, Securities Market Regulator for listed companies, etc.). The Steering Committee should determine the most effective institutional design in light of the proposed amendments to the statutory framework, and drawing on good international practice, which is evidenced in the GDLN Advanced Program in Accounting and Auditing Regulation.⁵² In addition, one issue that could be readily addressed by regulators and would have a positive effect on strengthening enforcement would be for regulators to refuse to accept disclaimers or qualified audit reports. Rather, such qualifications should immediately trigger on-site examinations and/or restatements of the financial reports.

⁵² Please refer to footnote 45.