

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

## FYR Macedonia

### ACCOUNTING AND AUDITING

June 24, 2003

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#### Executive Summary

This report on institutional arrangements for the observance of the International Accounting Standards (IAS) and International Standards on Auditing (ISA) in the Former Yugoslav Republic of Macedonia (FYR Macedonia) is based on a review conducted by the World Bank in cooperation with the Ministry of Finance and in-country stakeholders.

The current Trade Company Law requires all entities to comply with a translated 1999 volume of IAS. The Government is currently preparing a new Trade Company Law and has taken proactive steps to update the translation of IAS, which is expected to resolve existing deficiencies.

In practice, compliance with IAS is not effectively enforced. Most of the financial statements reviewed by the ROSC team were of such poor quality as to preclude investors and other users from judging whether a company's securities were a sound investment; nor could the documents be relied on for other decisionmaking purposes.

This report recommends that public interest entities be required to use IAS. It also recommends that small- and medium-size enterprises be allowed to use a reporting framework more adapted to their size. This report also recommends strengthening accounting standards enforcement mechanisms in order to enhance compliance with the law and provide investors and other users of financial statements with reliable financial reporting.

In law, FYR Macedonia requires audits to be conducted in accordance with a translated version of the 1999 ISA. This translation has not been updated to reflect the current ISA. In addition, there are serious audit quality issues. These are exacerbated by the absence of an adequate professional organization. Drawing on recent international experience in developed economies and accession countries, this report recommends the establishment of a regime of delegated regulation of the auditing profession, subject to adequate oversight. The Government is currently preparing a new Audit Law that is expected to resolve existing deficiencies and be in conformity with the *acquis communautaire* (European Union law).

## I. INTRODUCTION

1. This assessment of accounting and auditing practices in the Former Yugoslav Republic of Macedonia (FYR Macedonia) is part of a joint initiative of the World Bank and the International Monetary Fund (IMF) to prepare Reports on the Observance of Standards and Codes (ROSCs). The assessment focused on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting. International Accounting Standards (IAS)<sup>1</sup> and International Standards on Auditing (ISA) served as benchmarks for the assessment, which involved a review of both mandatory requirements and actual practice.

2. The FYR Macedonia has a population of 2 million and a per capita Gross Domestic Product (GDP) of US\$1,690.<sup>2</sup> There were 45 companies listed on the Macedonian Stock Exchange with a market capitalization of US\$142,000 as of end-2001. During 2002, 55 additional companies listed their shares on the Macedonian Stock Exchange following the enactment of tax incentive laws for listed companies. However, trading in shares remains very limited. Listed bond volume amounted to US\$11.2 million as of end-2002. On average, these bonds are traded at a 34 percent discount to their nominal value. There are 21 banks operating in the Macedonian banking system, with banking assets totaling US\$1.8 billion. There are seven insurance companies, which wrote approximately US\$67 million in premiums in 2002.

3. Since the Stabilization and Association Agreement in April 2001, the economic orientation of FYR Macedonia has moved increasingly toward Western Europe, with integration in European Union (EU) a goal among country leadership. While EU membership is not an immediate goal, it has been a driving force in the adoption of accounting and auditing reforms, and the *acquis communautaire* is an important benchmark for country authorities and stakeholders.<sup>3</sup>

## II. INSTITUTIONAL FRAMEWORK

### A. Statutory Framework

4. **FYR Macedonia seeks gradually to (a) improve the quality, comparability, and transparency of the financial information provided by companies; (b) improve the quality of statutory audit; and (c) comply with IAS, ISA, and the *acquis communautaire*.** Accounting and audit are mainly regulated by the Trade Company Law (1996), the Audit Law (1997), and secondary legislation adopted on the basis of these laws. The Government is currently preparing a new Trade Company Law replacing the 1996 Trade Company Law. The new Trade Company Law is expected to resolve existing deficiencies noted in the following paragraphs.

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<sup>1</sup> In this report, International Accounting Standards refer to International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board, the Standards issued by the Board of the International Financial Accounting Standards Committee, and each applicable Interpretation of the International Financial Reporting Interpretations Committee.

<sup>2</sup> Translated based on the rate applicable at December 31, 2002 [Macedonian Denars (MKD)62=US\$1].

<sup>3</sup> The *acquis communautaire* comprises the relevant Directives and Regulation, but also the “soft *acquis*” of the European Commission recommendations on auditor’s independence (May 16, 2002) and on quality assurance for the statutory audit (November 15, 2000), as well as the “looming *acquis*” flagged in the Communication of the European Commission to the Council and the Parliament “Reinforcing the Statutory Audit in the EU” dated May 21, 2003.

5. **The Trade Company Law (1996) requires all companies to prepare annual accounts, including a balance sheet and income statement.** In accordance with the Trade Company Law, the Minister of Finance prescribes the format and contents of the balance sheet and income statement, which apply to non-financial enterprises, insurance companies, and banks and other financial institutions.<sup>4</sup> Balances disclosed in the financial statements are measured in accordance with a translated 1999 volume of the IAS published in the Official Gazette.<sup>5</sup> Because FYR Macedonia has a written law tradition, all IAS enacted after 1999 and all post-1999 amendments to existing IAS are not applicable in FYR Macedonia, as they were not published in the Official Gazette.<sup>6</sup> Therefore, financial statements prepared in conformity with the 1999 translation cannot claim compliance with “full IAS,” as “financial statements should not be described as complying with IAS unless they comply with all the requirements of each applicable Standard and each applicable Interpretation of the Standing Interpretations Committee.”<sup>7</sup>

6. **Banks are required to present legal entity financial and consolidated statements in conformity with the 1999 translation of IAS.** Some banks prepare voluntary financial statements in accordance with full IAS, which are required by foreign shareholders and correspondent banks. These financial statements are generally audited by the local member firms of international audit firm networks. The Banking Act does not set out specific filing or publication requirements for general-purpose financial statements. Therefore, banks merely have to comply with the requirements set out in the Trade Company Law (1996), which generally require publication of abridged financial statements in the Official Gazette within 15 days of their approval by shareholders (effectively within seven months of the year-end). This requirement is ineffective, as it does not ensure a timely disclosure of all information necessary for a complete accounting and disclosure to regulators, investors (in the case of listed banks), depositors, and other stakeholders. Abridged disclosure is inadequate because the absence of all financial statement components, and in particular the absence of note disclosures, precludes investors from judging whether a bank’s securities are a sound investment and other users to use financial statements for other decisionmaking purposes.

7. **The Securities Act imposes additional filing requirement on listed companies.** Listed companies are required to publish abridged financial statements in the Official Gazette and submit them to the Securities and Exchange Commission within 15 days of their approval by shareholders.<sup>8</sup> The Securities Act does not impose specific accounting or auditing requirements on listed companies.

8. **The Securities Act and secondary legislation do not define with precision what financial statements have to be included in a prospectus used for registration of securities**

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<sup>4</sup> The format of the balance sheet and income statement prescribed by the Minister of Finance applies to large and medium enterprises. Simplified balance sheet and income statement apply to small enterprises.

<sup>5</sup> The Trade Company Law requires a company to prepare consolidated financial statements if it owns more than 50 percent of the equity in one or more subsidiaries, unless the subsidiary is immaterial to the consolidated financial statements. This may conflict with IAS 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*, as IAS 27 requires consolidation when a parent controls one or more enterprises. Under IAS 27, control may also exist even when the parent owns one half or less of the voting power in an enterprise.

<sup>6</sup> The Government has taken proactive steps to update the translation of IAS in cooperation with a bilateral aid organization. The International Accounting Standards Board has indicated its willingness to recognize the Macedonian translation as an official translation.

<sup>7</sup> See paragraph 11, IAS 1, *Presentation of Financial Statements*.

<sup>8</sup> The issue relating to late and incomplete filing highlighted in paragraph 8 above remains valid.

**with the Securities and Exchange Commission.** The law merely requires that issuers of securities to the public include an audited balance sheet and income statement for the last two years preceding the offering. The law requires neither a cash flow statement nor a statement of changes in equity and explanatory notes. The law does not specify which financial reporting framework is required or authorized (for example, full IAS or the 1999 translation). The ROSC team reviewed a sample of ten prospectuses filed in 2002: most of the financial statements were of such poor quality that investors would be unable to ascertain whether a company's securities were a sound investment.

9. **The Insurance Act does not set specific accounting, auditing, and reporting requirement regarding insurance companies.** The Insurance Supervision Department of the Ministry of Finance is drafting secondary legislation regarding the determination of technical reserves and other regulatory accounting requirements. The Department does not distinguish between regulatory and general-purpose financial statements.

10. **Macedonian enterprises face significantly greater audit burdens than enterprises in most, if not all, European Union (EU) member states.** The Trade Company Law (1996) requires audits of large and medium sized joint stock companies, all companies that are required to prepare consolidated financial statements, all listed companies, and all large limited liability companies. Large limited liability companies are those that exceed two of three thresholds—balance sheet total (Euro 750,000), net turnover (Euro 3,000,000), and number of employees (150). These thresholds are considerably lower than those in the EU Fourth Directive, and may result in the audit of financial statements when there is no public interest requirement. Such over-extensive audit requirement undermines audit quality, even for the large public interest entities,<sup>9</sup> as the entire culture of quality and compliance becomes polluted, with no countervailing safeguards. The Law requires that statutory audits be conducted by registered audit firms (see Section II.B). Consequently, an individual auditor is not allowed to conduct an audit.

11. **Financial statements filed with the Public Revenue Office and the annual account register within the Central Registry are abridged. Such abridged statements may mislead investors and other users.** The Trade Company Law requires that annual accounts (legal entity balance sheet, income statement, and report) be filed at the Public Revenue Office and the annual account register within the Central Registry within two months of the year-end. In essence, the forms are an abridged version of the full set of financial statements (for example, the cash flow statement and explanatory notes are not required). Registry clerks and temporary workers then enter these forms the Registry's system (approximately 40,000 companies in total). The process is ineffective from an operational point of view, and the information available to investors and other users may actually be misleading because of the limited disclosure.

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<sup>9</sup> Public interest entities may be defined by the nature of their business, their size, or their number of employees; or by their corporate status by virtue of their range of stakeholders. Examples of *public interest entities* might include banks, insurance companies, investment funds, pension funds, listed companies, and large enterprises. For example, limited liability companies and groups of enterprises that meet two of three following thresholds should be considered as public interest entities—(a) total number of employees including exceeding [a number to be decided in consultation with various stakeholders]; (b) total assets on the balance sheet exceeding [amount to be decided in consultation with various stakeholders]; and (c) total turnover exceeding [amount to be decided in consultation with various stakeholders].

## B. The Profession

12. **The auditing profession in FYR Macedonia is not adequately organized.** Two accounting and auditing associations compete to represent the professional community: (a) the Association of Accountants, Financial Workers, and Auditors (Sojuz), which was established in 1956; and (b) the Macedonian Association of Certified Auditors, which was established more recently. Both membership are voluntary and do not confer any privileges on members. These associations lack the capacity to sustain themselves as modern professional organizations.

13. **In the absence of a robust professional organization, the Ministry of Finance regulates the auditing profession.** The Ministry of Finance is sponsoring draft legislation recognizing the profession as self-regulated and independent and requiring a professional organization to regulate professional performance as a matter of public interest. In the meantime, the Ministry remains the regulatory body, as evidenced by its prominent role in the organization and conduct of professional examinations and licensing of auditors.

14. **The auditing profession is in disarray and the Ministry of Finance lacks the capacity to regulate it effectively, which severely hampers the auditor's watchdog function.** The financial architecture of FYR Macedonia is missing one of the required pillars to ensure the reliability of financial statements: a reliable, independent auditing profession whose ultimate allegiance is to a company's creditors, shareholders, and other stakeholders. The Ministry of Finance does not have the resources to organize and monitor continuing professional education; enact and implement auditing standards and a professional code of ethics for auditors; and control the quality of audit activity and auditors' professional conduct. These fundamental activities, which are generally handled by a professional organization, are simply not addressed in FYR Macedonia.

15. **Although approximately 900 companies are required to be audited, there are only 24 licensed auditors in public practice<sup>10</sup> and only 11 audit firms are registered with the Ministry of Finance.** This shortage is exacerbated by the December 31 year-end. Reducing the number of firms that must be audited, by taking maximum advantage of the EU Fourth Directive's auditing exemption for small- and medium-size enterprises when there is no public interest requirement for the audit of financial statements, would help resolve this issue. Establishing a well-functioning professional organization would also help address the shortage of auditors.

16. **FYR Macedonia has enacted the 1998 version of the International Federation of Accountants (IFAC) Code of Ethics for Professional Accountants, however the existing auditor independence requirements are not enforced.** The Audit Law prohibits a statutory auditor from performing bookkeeping, appraisal, or tax services for a client contemporaneously with the audit of the financial statements of the client. Observers note widespread noncompliance with this auditing profession requirement for independence. One audit firm in FYR Macedonia reportedly audits the financial statements of a company where one of its audit partners serves on the Board of Directors. Also, certain audit partners incorporate two separate legal entities (for example, an audit firm and a consulting company) to circumvent the letter of the law. Finally,

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<sup>10</sup> The Audit Law does not allow an individual (sole auditor) to conduct an audit. Auditors in public practice must be employed by (or be partners) in an audit firm. Among the 70 individuals who obtained an audit license from the Ministry of Finance, only 24 are in public practice. The balance are employed as corporate accountants, faculty members, and so forth.

these rules fall short of the November 2001 IFAC Code of Ethics for Professional Accountants and the European Commission Recommendation on auditor's independence (May 16, 2002).

17. **The Macedonian legislation relating to the liability of audit firms and auditors is vague and untested.** Under the Audit Law, an auditor or an audit firm is obliged to provide auditing services duly and carefully and to observe the rules of the profession. An auditor has so-called "objective liability" for any damages incurred in connection with the services the auditor provides, and may be released from such liability only if he/she proves having exercised all reasonably required efforts. However, the Law fails to say expressly whether parties other than the audited company (e.g., creditors, investors, or any person relying in good faith on the auditor's opinion) may have a direct recourse against the auditor. In the absence of such provision, Macedonian lawyers contend that third parties would be in a difficult position to prove before a Macedonian court that they have privity and legal standing to pursue the claim for damages against the auditor. It is also uncertain whether the auditor is liable for damages vis-à-vis the regulatory authorities other than the National Bank. This issue appears even more significant considering a lack of landmark Macedonian court decisions on these matters. The ROSC team is unaware of any civil or criminal decision of Macedonian courts on a claim against auditors.

18. **The Audit Law requires audit firms to take out professional indemnity insurance, but the amount of insurance coverage is not in the public domain.** In the event that the auditor's insurer does not satisfy the plaintiff's claim for damages, plaintiff may initiate judicial proceedings against the audit firm and against any or all of the auditors (individuals) who have participated in providing the audit services. Audit firms are incorporated as a limited liability company with very low share capital, which offers little protection to claimants.

### C. Professional Education and Training

19. **Although universities started adapting their curricula approximately five years ago to cover internationally recognized accounting and auditing standards, some faculty members are not up to date with recent accounting trends.** In addition, the quality of accounting education is compromised by the lack of IAS training material translated into Macedonian.

20. **University curricula do not cover business ethics.** Academic institutions in FYR Macedonia place little emphasis on the study of business ethics. Formal education can enhance aspiring professionals' awareness of ethical problems and can influence their reasoning and judgment with respect to ethical dilemmas.

21. **An auditor must have acquired appropriate higher education, obtained relevant practical experience, and passed the professional examination administered by the Commission appointed by the Ministry of Finance.** The Audit Law requires the following:

- ***To qualify as a trainee*** one must have graduated from college.
- ***To qualify as an auditor*** one must have obtained three years of additional practical experience in auditing or five years in accounting; and passed the examination that covers areas such as economy and financial management, accounting, and auditing standards.

Observers note that audit trainees prefer to attend the program of the United Kingdom's Association of Chartered Certified Accountants (ACCA). Although expensive, the program is taught locally, and its international recognition appeals to young professionals. The local member

firms of international audit firm networks generally sponsor staff enrollment in the ACCA program. It is not clear whether there is a bridge between the ACCA program and the examination organized by the Ministry of Finance.

22. **Observers noted significant improvements in the administration of professional examinations since May 2002. These improvements in professional examination provide assurance to the public that candidates who pass will possess the requisite knowledge and skills, and that candidates are treated fairly and objectively.** Prior to the May 2002, the professional examination was laden with a series of security lapses that compromised the exam and called into question not only the results of the exam but the entire administrative process. However, the study material to prepare for the examination still needs improvement. While the existing examination does not yet fully comply with IFAC International Education Guideline No. 9, *Prequalification Education, Assessment of Professional Competence and Experience Requirements of Professional Accountants*, the exam is now credible and certainly evolving in the right direction.

23. **No mechanism exists for screening the providers of practical training for prospective auditor.** The audit trainee receives professional coaching by a licensed auditor of his or her own choosing. There is no supervision of the quality of the three- or five-year practical training.

24. **Licensed auditors are not required to participate in continuing professional education (CPE) to maintain and improve their professional competence and to meet public expectations for quality work by the profession.** Auditors are faced with increased knowledge requirements. Public expectations also demand high-quality output from financial statements and independent audits. Continuing professional education must be recognized as one of the solutions to meeting these professional goals.

#### **D. Setting Accounting and Auditing Standards**

25. **Accounting regulation is driven by the Ministry of Finance, which also regulates and collects taxes.** Going forward, adequate checks and balances must be established to ensure that the accounting standard-setting process takes into account the needs of all users of general-purpose financial statements.

26. **The Macedonian Accounting Standards Committee (MASC) may grow into a national standard setter.** The MASC was established by an amendment to the Trade Company Law (1996). Although the Committee is not yet operational, it may be an appropriate platform for developing a policy regarding the use of IAS and for carrying out important accounting standard-setting functions.

27. **Although the Macedonian translation of IAS is readily available, it is outdated and inaccurate.** The 1999 volume of IAS was translated and published in the Official Gazette, and it was therefore endorsed as the national accounting standards. While the ROSC team acknowledges that FYR Macedonia's written law tradition requires giving IAS legal endorsement for its use in FYR Macedonia, the current environment does not enable timely translation and adoption of new International Financial Reporting Standards, amendments to existing standards, and Interpretations.

28. **Macedonian standards on auditing follow the ISA in existence in 1999, translated into Macedonian.** All ISA enacted after 1999 and all amendments to existing ISA are not

applicable in FYR Macedonia, as they were not published in the Official Gazette. The Government has taken proactive steps to update the translation of ISA in cooperation with a bilateral aid organization.

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

29. **No effective mechanism exists for enforcing the accounting and financial reporting requirements provided in the Trade Company Law.** The Central Registry and the Ministry of Finance do not take proactive measures to monitor and enforce accounting and auditing requirements.

30. **The Securities and Exchange Commission does not review the financial statements of listed companies to determine if the companies have met their disclosure requirements.** Because of resource constraints and lack of accounting expertise, the Securities and Exchange Commission does not review the financial statements for coherence and completeness. The Commission has never ordered a restatement of financial statements, which suggests that it lacks a process to enforce accounting standards effectively. The Macedonian Stock Exchange, too, does not enforce accounting standards.

31. **The existing legal system does not provide the Securities and Exchange Commission with the necessary powers to conduct monitoring and enforcement of the highest level of professional implementation of IAS by listed companies and the highest standards of ethical behavior and implementation of ISA by auditors.** The Securities Law does not authorize the Commission to levy fines; it also does not provide the Commission powers to elicit information from auditors, including the power to require making available audit work papers, and to conduct special inspections on its own initiative.

32. **The National Bank of the Republic of Macedonia and the Insurance Supervision Department of the Ministry of Finance lack arrangements to enforce accounting standards that are applicable for general-purpose financial statements of banks and insurance companies, respectively.** The National Bank reviews banks' financial statements, but the primary responsibility for enforcing accounting standards rests with auditors.<sup>11</sup> The Insurance Supervision Department does not enforce accounting standards.

33. **There is no mechanism for independent external review of the quality assurance arrangements in audit firms.** The IFAC and the European Commission recommend that the professional organization in a country assume responsibility for developing quality control standards and relevant guidance, requiring audit firms to establish quality control policies and procedures that provide reasonable assurance that services provided conform to professional standards. To ensure that audit firms have effective quality control arrangements, a mechanism of independent external review must be in place. However, because of the absence of a strong professional organization, there is no mechanism for independent external review of the quality assurance arrangements in audit firms.

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<sup>11</sup> General-purpose financial statements are prepared based on the same accounting standards as those for regulatory reporting.



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

34. **There are differences between the translated IAS applicable in FYR Macedonia (the 1999 translation) and the current IAS (full IAS).** These differences may have an adverse impact on the quality of financial statements. Selected differences include the following:

- **Conceptual framework.** The International Accounting Standards Board (IASB) framework sets out the concepts that underlie the preparation of general-purpose financial statements. The 1999 translation does not include several sections of the IASB framework, including the sections dealing with the qualitative characteristics; the elements, recognition of the elements, and measurement of the elements of the financial statements; and the concepts of capital and capital maintenance. As a result, Macedonian standards do not require that the information presented be relevant to the decisionmaking needs of users. In the IASB framework, materiality is part of relevance. Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. The IASB framework therefore requires that financial statements disclose all items that are material enough to affect evaluations or decisions. The omission of certain key sections from the IASB framework may adversely affect the quality of financial statements in FYR Macedonia.
- **Interpretations of IAS.** The International Financial Reporting Interpretations Committee assists the IASB in providing timely guidance on newly identified financial reporting issues not specifically addressed in IAS or issues where unsatisfactory or conflicting interpretations have developed. FYR Macedonia has not endorsed any of the 31 existing interpretations. This may hamper rigorous and uniform application of IAS in FYR Macedonia.
- **Investment property.** IAS 40, *Investment Property*, which prescribes the accounting treatment for investment property and related disclosure requirements, was not adopted in FYR Macedonia. Therefore, investment properties (for example, real estate held in the investment portfolio of an insurance company) are still accounted for in conformity with IAS 25, *Accounting for Investments*, which was withdrawn outside of FYR Macedonia. Under IAS 25, a company is permitted to choose from a variety of accounting treatments for investment property (depreciated cost, revaluation with depreciation, and cost less impairment).

While these shortcomings may not be critical for certain enterprises, accounting standards for public interest entities should produce more transparent numbers and consistency, which together help steer capital to the companies that most deserve it from a financial investment perspective.

35. **Bank regulatory accounting requirements affect the preparation of general-purpose financial statements.** Banks are required to prepare their financial statements in accordance with the 1999 translation of IAS. However, banks calculate impairment in the secured and unsecured portion of loans and receivables on the basis of a provisioning matrix that specifies fixed provisioning rates for the number of days a loan has been classified as nonperforming (as required by the National Bank). The results may differ from the recoverable amount of originated loans and receivables under IAS 39, *Financial Instruments: Recognition and Measurement*. 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.<sup>12</sup>

36. **Companies present IAS-based financial statements that are abridged financial statements with a complete audit report.** Several reports reviewed by the World Bank ROSC team included only the balance sheet, income statement, cash flow statement, and statement of changes in equity (some did not include the last two statements). None of these financial statements included accounting policies or note disclosures. In each case, the abridged financial statements included an audit report, usually from a local member firm of international audit firm networks, which expressed the opinion that the financial statements “presented fairly” the financial position and performance of the audited company in accordance with IAS. These opinions are incorrect. They may be correct opinions if attached to complete IAS-based financial statements. However, the attachment of such audit opinions to abridged financial statements may mislead readers of the financial statements.

37. **General-purpose financial statements are often influenced by the taxation rules and regulations.** To satisfy the requirements of taxation authorities regarding recognition of revenues and expenses, the preparers of general-purpose financial statements of small- and medium-size private companies and public interest entities often tend to deviate from applicable financial reporting standards and follow tax rules in choosing the method of accounting treatment in various areas. For example, companies do not provide for bad debt until such time as they sue the debtor, or the receivable is three-years overdue, which results in severely overstated accounts receivables. Transparency and accountability suffer from this emphasis on tax.

38. **The review of abridged and complete IAS-based financial statements revealed significant variations in the level of compliance with IAS.** The ROSC team reviewed the IAS-based financial statements of a sample of companies listed on the Macedonian Stock Exchange, banks, insurance companies, and large companies. In addition to the missing information in abridged financial statements, there were several other instances of accounting policies or presentations that did not comply with IAS. The related audit reports were not qualified, perhaps because the auditors did not consider these issues a material departure from IAS:

- ***Related-party relationships and transactions.*** The financial statements of many sample companies did not provide information on related-party relationships. Also, adequate information was unavailable to determine the magnitude of related-party transactions. However, an examination of the operational activities and company structures indicates that these companies had related parties. In additional explanatory notes, some companies provided aggregated information on related-party transactions that was not in compliance with the requirement for detailed disclosures.
- ***Revaluation of property, plant, and equipment.*** Companies used general price indices to revalue property, plant, and equipment, a procedure that may not comply with IAS 16 *Property, Plant and Equipment*.
- ***Revaluation of intangible assets.*** Companies used general price indices to revalue intangible assets. This procedure does not comply with IAS 38, *Intangible Assets*.
- ***Measurement of financial assets at fair value.*** Companies failed to measure some financial assets at fair value and had only limited disclosure about the fair value of

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<sup>12</sup> Activities are being undertaken in the Republic of Macedonia in order to fully harmonize the regulations in the area of accounting for banks and other financial institutions with IAS and EU Directives, as well as the other legal regulations for these entities.

financial assets. Many companies implied that carrying amounts always approximated fair value, which may conflict with IAS 32, *Financial Instruments: Disclosure and Presentation*, and IAS 39. Fair value information is of paramount importance in determining an enterprise's overall financial position and in making decisions about individual financial instruments. Fair values provide a neutral basis for assessing management's stewardship by indicating the effects of its decisions to buy, sell, or hold financial assets, and to incur, maintain, or discharge financial liabilities. Hence, failure to disclose fair value information through supplementary disclosures adversely affect the relevance of Macedonian financial statements.

- **Compound financial instruments.** Companies failed to apply split accounting for compound financial instruments (for example, debt security with an embedded conversion option) as required by IAS 32. Since the economic effect of issuing a convertible bond is substantially the same as issuing simultaneously a bond with an early settlement provision and warrants to purchase common shares, IAS requires issuer to present the liability and equity elements separately on its balance sheet.
- **Consolidation.** Companies failed to consolidate subsidiaries (particularly loss-making subsidiaries) in circumstances that appear inconsistent with the principles in IAS 27. Also, companies failed to eliminate intragroup revenues and expenses in consolidated financial statements, which does not comply with IAS 27.
- **Cash flow statements.** The classification in the cash flow statements of several banks of cash flows from loans and advances as cash flows from investing activities, and cash flows from deposits as cash flows from financing activities, does not comply with IAS 7, *Cash Flow Statements*. Such classification presents a biased picture of a bank's operations.
- **Understatement of expenses.** Payments to management and employees were charged to equity instead of being recognized as expenses, resulting in an understatement of expenses.

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

39. **There are differences between the translation of ISA applicable in FYR Macedonia and current ISA. These differences may have an adverse impact on audit quality** The differences stem from amendments made to ISA since 1999, which were not endorsed in FYR Macedonia. Selected differences include the following:

- **Fraud and error.** The revised ISA 240, *The Auditor's Responsibility to Consider Fraud and Error*, has not been endorsed in FYR Macedonia. The revised ISA 240 clarifies the role of auditors, management, and those charged with governance of an entity with respect to fraud and error in financial statements. It would be of particular interest in a marketplace that continues to provide an environment where the potential for financial statement fraud exists.
- **Communication of audit matters.** The IFAC issued ISA 260, *Communications of Audit Matters with those Charged with Governance*, in 1999. The purpose of this ISA is to establish standards and provide guidance on communication of audit matters arising from the audit of financial statements between the auditor and those charged with governance of an entity (for example, the supervisory board). This standard may play an important role in making these persons more accountable throughout the financial reporting process.

Although some audit firms voluntarily elect to conduct their audit in accordance with up-to-date ISA, the ROSC team noted that a number of auditors stick to letter of the law and only follow the standards as published.

40. **Few shareholders, directors, and members of management understand the purpose of an audit, which makes audit evidence difficult to obtain.** Although this problem occurs in other countries, including those with developed audit requirements and practice, the extent of some problems is more widespread in FYR Macedonia than in other countries. There is an obvious need for more education of investors, directors, and members of management, which could be addressed under the ROSC corporate governance module. The banking sector could also play an instrumental role in requiring audited financial statements from borrowers, not as part of a box-ticking exercise that affords the banks no extra protection, but rather as a key element of their credit risk assessments. The banks may also develop an internal register of acceptable auditors based on prior experience, and thereby foster the development of quality audits.

41. **The review of the audit reports on IAS-based financial statements revealed several instances in which local member firms of international audit firm networks had failed to comply with ISA 700, *The Auditor's Report on Financial Statements*.** ISA 700 specifies the principles that auditors should follow in deciding whether to issue an unqualified, qualified, adverse, or disclaimer of audit opinion, and when to issue an “emphasis of matter.” In several instances, auditors (including some local member firms of international audit firm networks) applied these principles wrongly, for example:

- ***Material disagreement and emphasis of a matter paragraph.*** One audit firm issued an “emphasis of matter” paragraph notwithstanding that its audit opinion indicated a material disagreement with management over the basis for the revaluation of property, plant, and equipment. The firm should have issued a qualified audit opinion, as another firm did in similar instances.
- ***Implied material disagreement and emphasis of a matter paragraph.*** One audit firm issued an “emphasis of matter” paragraph that implied a material disagreement with management over the measurement of impaired loans by a bank. The firm should have issued a qualified audit opinion.
- ***Qualified opinion instead of adverse opinion.*** One audit firm issued a qualified audit opinion with respect to the company’s failure to eliminate intragroup revenues and expenses. The amounts involved were so material (25 percent of revenue and 126 percent of profit) that an adverse opinion should have been issued.

42. **Clients lack financial reporting expertise and therefore expect the auditors to prepare their financial statements.** There is evidence that audit firms are involved extensively in the preparation of financial statements on behalf of their clients. This practice has implication for ownership by preparers of their financial statements, and raises issues of audit independence. In addition, two companies referred in their annual reports to their IAS-based financial statements being the audit or auditor’s report. These references may suggest that management does not take responsibility for the financial statements. It may also imply limited management involvement in the preparation of those financial statements, which undermines the credibility of the financial statements.

## V. PERCEPTIONS ON THE QUALITY OF FINANCIAL REPORTING

43. **Banks are the primary users of financial statements; generally they consider that audit quality needs to be enhanced and enforcement mechanisms strengthened to improve the quality of corporate financial reporting.** Investors, lenders, and other users place little reliance on the information contained in the published corporate financial statements. Most interviewees consider that bank financial statements are generally more reliable than those of companies in the commercial/industrial sector (few observers commented on insurance companies). In the commercial/industrial sector, interviewees generally consider the financial statements prepared by joint stock companies (audited) as more reliable than those prepared by limited liability companies (unaudited). Observers unanimously cited tax evasion or fraud as the core motivation behind accounting improprieties. Most interviewees shared a strong view that the quality of financial reporting would improve when there is a strong regulatory regime combined with effective enforcement mechanisms to ensure compliance with accounting and auditing standards and with the auditor's professional ethics.

## VI. POLICY RECOMMENDATIONS

44. The following policy recommendations were agreed between the World Bank, the Ministry of Finance, and country stakeholders. It was also agreed that a detailed country action plan would be developed and implemented on the basis of these policy recommendations. The country action plan, developed by in-country stakeholders, will be implemented under the coordination of the Ministry of Finance, with assistance from international development partners.

45. **Amend accounting and auditing laws and standards.** The law should be amended and other measures taken to incorporate the following legislative recommendations:

- ***Financial reporting by public interest entities.*** IAS and related interpretations issued by the IASB should be mandatory for the financial statements of all public interest entities. The audit of financial statements prepared by public interest entities should be carried out in accordance with the ISA and with other related pronouncements issued by IFAC.
- ***Financial reporting by small- and medium-size enterprises and microenterprises.*** The legislation should provide small and medium-size enterprises with a reporting framework more adapted to their size. It should take maximum advantage of the accounting and auditing exemption in the EU Fourth Directive for small- and medium-size enterprises when there is no public interest requirement for the preparation, publication, or audit of financial statements.
- ***Community law.*** A working group should undertake a comprehensive review of primary and secondary legislation compared to the *acquis communautaire* to identify existing discrepancies and propose amendments where necessary. In addition, FYR Macedonia will need to keep abreast of future developments, rather than just adopt a new system now and leave it unchanged/unreviewed going forward.
- ***Auditing law and standards.*** The Legislature should incorporate in the Audit Law currently being revised the provisions within the *acquis communautaire*.

All these measures are conditional upon the establishment of a well-functioning professional organization.

46. **Enhance accounting and auditing standard-setting and interpretations.** Accounting and auditing standard-setting and interpretation mechanisms should be reviewed to ensure the adoption of IAS and ISA and the transparency of the due process and to better represent the public interest regarding Macedonian accounting standards.

- **Accounting standards.** The adoption of IAS for public interest entities requires the establishment of a sustainable system in the appropriate body (a) to enable immediate translation and adoption of new International Financial Reporting Standards and exposure drafts issued by the International Accounting Standards Board, and new interpretations developed by the International Financial Reporting Interpretations Committee (IFRIC);<sup>13</sup> and (b) to issue implementation guidelines on individual IAS that should link into IFRIC.

As Macedonian accounting standards remain applicable to small- and medium-size enterprises, the accounting standard-setting body should be composed of professional accountants, business representatives, regulators, and other stakeholders, such as the Ministry of Finance and the tax authorities. All of the standard setter's work and discussions should be made public, as should the procedures set out in its by-laws.

The Macedonian Accounting Standards Committee may be an appropriate platform to carry out these important accounting standard-setting functions. The Macedonian Accounting Standards Committee may want to enter into a twinning or cooperation arrangement with an accounting standard setter in an EU Member State to gain technical expertise.

Regulators should make clear the distinction between prudential and general-purpose financial reporting. Therefore, regulatory accounting requirements (e.g., loan loss provisioning in the banking sector) should not affect IAS-based financial statements. Where the regulators need additional (unpublished) information for prudential supervision purposes, this should be by way of topping-up IAS. However, since the regulators would have a keen interest in ensuring that the fundamental IAS-based financial statements are correct—since their reports would be built on that foundation—this would mobilize them to assist in the enforcement of shareholder- or stakeholder-oriented financial statements as well.

- **Auditing standards.** The adoption of ISA for public interest entities requires the establishment of a sustainable system in the professional organization (a) to enable immediate translation and adoption of new ISA and exposure drafts issued by IFAC; and (b) to develop audit guidance related to individual ISA.

47. **Strengthen filing and full real-time access of legal entity and consolidated financial statements.** The law should be amended and enforcement mechanisms reviewed, as follows:

- For *public interest entities*, publication requirements should be strengthened in terms of timeliness and electronic availability. Audited legal entity and consolidated financial statements should be published in a timely manner. Financial statements should be reproduced in the same form and text as was subject to audit and should be accompanied by the full text of the auditor's report. The publication of the auditor's report without the full financial statements should be prohibited.

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<sup>13</sup> The Accounting Reform Program (ARP), part of the overall Macedonian Financial Sector Strengthening Project (MFSSP) funded by United States Agency for International Development is in the process of discussing with the IASB in London the steps necessary to accomplish this objective.

- Publication of abridged financial statements (in newspapers, in annual reports, and on websites) should be avoided or authorized only if the following actions are taken:
  - Abridged financial statements are appropriately titled to identify the audited financial statements from which they have been derived, for example, “Summarized Financial Information Prepared from the Audited Financial Statements for the Year Ended December 31, 2002.”
  - Auditor’s report accompanying the abridged financial statements is in accordance with ISA 800, *The Auditor's Report on Special Purpose Audit Engagements*, and among other things, includes the statement, “For a better understanding of the Company’s financial position and the results of its operations for the period and of the scope of our audit, the summarized financial statements should be read in conjunction with the financial statements from which the summarized financial statements were derived and our audit report thereon.”
  - Audited financial statements are readily available to all interested parties and the publication states where the full set of audited financial statements can be obtained.

Article 49 of the EU Fourth Directive provides for similar caveats relating to the publication of abridged financial statements—though the wording is slightly different.

48. **The Government of the FYR Macedonia needs to ensure that the auditing profession is properly regulated.** These regulatory responsibilities are in the first instance responsibilities of the State. However, in deciding how to regulate, the Government can choose to delegate certain regulatory powers to a professional organization, but only on condition that this organization has the necessary resources, appropriate governance structures, accountability to the State for the exercise of its regulatory functions, and is subject to proper external oversight. The recommendation is that the Government establishes a system of “delegated regulation subject to oversight” (rather than a self-regulatory system as described in paragraph 15 above) with the clear understanding that if the professional organization does not perform, it loses its regulatory powers. Therefore, there is an urgent need in FYR Macedonia for a professional organization whose role would include the following:

- Organize and conduct professional examinations;
- Register auditors, maintain and publish special registers of auditors—individual persons and audit firms;
- Organize training for auditors;
- Ensure compliance with professional ethical standards;
- Translate new ISA and exposure drafts issued by IFAC and develop audit guidance related to individual ISA.
- Control the quality of audit activity and professional conduct of its members. The professional organization should develop a quality assurance system to ensure that auditors comply with applicable auditing and ethical standards, and with independence requirements. The system should include in-depth quality reviews of audit firms and specific audit engagements based on an established schedule, so that (a) every audit firm or sole practitioner, and (b) the audit working papers for every public interest entity would be subject to regular oversight (for example, every three

years). Remedies should provide for sanctions, including injunctions, fines, and temporary and permanent disbarment.

The professional organization may want to enter into a twinning arrangement with a professional institute in an EU Member State to gain technical expertise.

Appropriate public oversight of the auditing profession should be established that extends further than the oversight of the quality assurance required by the European Commission Recommendation of May 2002.

The European Commission recommends that quality assurance systems should have adequate public oversight with a majority of nonpractitioners on the overview board of the quality assurance system. This public oversight requirement is meant to ensure that the quality assurance is in fact and appearance an exercise with sufficient public integrity.

The European Commission recommends that there be a systematic link between negative outcomes of quality reviews and initiating sanctions under the disciplinary system. The disciplinary system should include the possibility of removal of the statutory auditor from the audit register. The link between quality reviews and disciplinary sanctions adds public credibility and is also logical, because quality assurance can be seen as an enforcement tool.

Therefore, the scope of the oversight might extend to education, licensing, standard-setting, quality assurance, and disciplinary systems. While the National Bank and the Securities Commission may be a proxy for representation of the public interest, the composition of the public oversight body should also take into account the role of other stakeholders.

49. **Strengthen oversight of accounting and auditing regulations.** The ROSC review has found significant a compliance gap relating to accounting and auditing standards. This gap and recent scandals have prompted calls for strengthening oversight arrangements, including the following:

- ***Powers to monitor and enforce IAS and ISA.*** Amend the existing regulatory framework to provide the necessary legislative changes required in a civil legal system that will provide the National Bank, the Securities Commission, and other regulators with the necessary powers to monitor and enforce (a) the highest level of professional implementation of IAS by public interest entities, and (b) the highest standards of ethical behavior and implementation of ISA by auditors.
- ***Monitoring and enforcing IAS at the national level.*** Establish monitoring and enforcement arrangements within the National Bank, the Securities Commission, and other regulators, which comply with the requirements expressed in recital 16 in the EU Regulation on the application of IAS. The enforcement processes should ensure that regulators render unbiased decisions, have transparent and clear procedures, investigate rapidly and confidentially, have a risk-based approach reflective of available resources, have appropriate means of rectifying defective financial information inconsistent with Macedonian law, and have the authority to impose sanctions or provide information that assists existing authorities to impose sanctions. It should be stressed that consistent and robust decisionmaking should not result in standard setting.
- ***Effective sanction mechanism.*** Impose realistic administrative, civil, and/or criminal penalties that are based on a civil law system on both auditors and natural or legal persons; and on officers, directors, or employees of the auditors or of the enterprise that assists or facilitates noncompliance with IAS or ISA.



50. **The major international networks of audit firms should ensure that when audits are carried out in accordance with ISA, their audit reports comply with ISA 700.** FYR Macedonia should consider requiring the local member firms of international audit firm networks—as a condition of using an international network name—to disclose sufficient information about the structure and operation of their respective networks and about their individual relationships with them. This disclosure would enable an audit report user to assess the extent of reliance that can be placed on the implicit quality assertion that underlies the use of a common international network brand name. Such disclosures could include, for example, a description of the quality standards applied by the networks, the quality assurance arrangements to enforce them, details of how frequently the individual member firm is subject to network review, and the date and results of the most recent review. This would force the networks to exercise a much higher standard of care with respect to the quality of their member firms—since their procedures would be publicly transparent—and would ensure that quality weaknesses are addressed rapidly.<sup>14</sup>

51. **Institute professional education and training.** In adopting IAS and ISA for public interest entities, FYR Macedonia has set challenging and demanding objectives for itself. This translates into a need for related education and training for preparers, auditors, and regulators. Training plans should encompass some of the following areas:

- **University curriculum.** Develop an accounting curriculum at college and universities that meets the needs of corporate FYR Macedonia. While the accounting major curriculum would include IAS training, it would most probably also include more business administration and case studies to ensure that the graduates are better prepared to operate as accountants (rather than bookkeepers or tax compliance officers) in corporate FYR Macedonia.

Review and update the accounting curricula in order to incorporate IAS and ISA and practically oriented teaching at the undergraduate level in higher educational institutions. The ethical dimensions of business management, corporate finance, and accounting and auditing should be taught with case studies in the undergraduate programs of business schools and commercial training faculties. Particular attention should be given to increasing the critical thinking skills of students. To enhance the capacity of higher educational institutions to teach accounting and auditing courses with international components, a training-the-trainers program should be organized. FYR Macedonia may seek the help of accounting institutes in an EU Member State in developing and organizing their train-the-trainers program.

- **Regulators.** Provide meaningful IAS theoretical and practical training to the staff of the Securities and Exchange Commission, the National Bank, and other regulators, so that they can enforce accounting standards as recommended.
- **Professional education.** Establish, monitor, and enforce continuing professional education in accordance with the IFAC International Education Guideline No.2, *Continuing Professional Education*.
- **Quality of training.** Arrangements should be made so that the professional accountancy body regularly monitors the quality of practical training provided by authorized training providers to trainee auditors.

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<sup>14</sup> The European Commission is confronted by the same problem as far as the networks and their EU member firms are concerned, and a potential avenue of action is indicated in Chapter 3.9 of their recent Communication “Reinforcing the statutory audit in the EU.”

- **IAS training.** Corporate accountants in public interest entities ought to be trained in IAS. Failure to provide rigorous training to corporate accountants will exacerbate the existing practice whereby audit firms are involved extensively in the preparation of IAS-based financial statements on behalf of their clients.

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