

3 GAP ANALYSIS

The purpose of this chapter is to undertake a gap analysis to identify the actions that are required to achieve the benchmarks identified in Chapter 2. The SC carried out a review of the existing situation through a series of interviews and meetings with key stakeholders to produce a summary of the progress made in the implementation of the recommendations of the ROSC and of the outstanding problems and issues that still need to be addressed.

3.1 The Statutory Framework for Accounting

A Framework Accounting and Auditing Law (the State Framework Law) was adopted in 2004. The State Framework Law sets out provisions of the general legal framework on the basis of which each Entity has prepared a Law that were adopted by their respective Parliaments.

The accounting and auditing laws specifically outlines the accounting standards to be:

- International Financial Reporting Standards (IFRS), produced by the International Accounting Standards Board (IASB), and related instructions, explanations and guidance issued by the IASB.

BiH has rightly adopted IFRS for public interest entities only and the Implementing Laws of the Entities use three criteria to define public accountability:

- (a) Having securities listed;
- (b) The nature of the business (for example, banks and insurance companies); and
- (c) The size of the business (exceeds thresholds regarding total yearly income or number of people employed).

In both the RS and FBiH, entities for which there is no public interest (e.g., SMEs) are exempted from having to comply with IFRS.

However there is still a lack of a common definition of company thresholds applied across BiH. In fact only the RS has introduced a definition of company thresholds.

The RS considers micro-sized enterprises those with average annual number of employees less than 10, annual total turnover less than €200,000 and assets value of less than €100,000.

The RS considers small-sized enterprises those with average annual number of employees between 10 and 49, annual total turnover between €200,000 and €10,000,000 and assets value of between €100,000 and €5,000,000.

The RS consider Medium sized enterprises satisfy the following criteria: 50 – 250 employees, minimum €10 million annual total turnover and minimum €5 million assets value. All entities above these thresholds are considered large enterprises.

Federation of Bosnia Herzegovina

In the Federation of Bosnia Herzegovina the Law on Business Companies (published, Official Gazette of FBiH 23/1999, amended 45/2000; 2/2002; 29/2003), which is partly based on EU Company Law Directives, primarily regulates business activities¹³. The Law on Business Companies recognizes the following types of companies:

- Joint stock,
- Partnerships (General & Limited),
- Limited liability.

Joint-Stock Company

Shareholders: One or more shareholders. Minimum capital: KM 50,000. Company management. The company is managed by a two-tier system including a management board and a supervisory board. A general meeting of shareholders appoints an auditing board. The auditing board is due to perform annual or 6-month auditing at the request of at least 10% of the shareholders with voting rights.

¹³ **Further relevant laws include:**

FBiH Company Registration - Companies have to be registered into an authorized court register on the respective entity's territory under the FBiH Law on Registration of Legal Entities (published, Official Gazette 27/05 of FBiH and 42/05, Official Gazette 29/03).

FBiH Bankruptcy Regulation - Legal framework: Bankruptcy Law (published, Official Gazette of FBiH 29/2003) and Law on Liquidation (published, Official Gazette of FBiH 29/2003).

FBiH Anti-Trust Rules - Legal framework: Law on Competition (published, Official Gazette of FBiH 30/2001)

Partnerships

Partners: Two or more partners - domestic or foreign individuals or legal entities. There are no requirements for minimum or maximum contributions. A partner may contribute in cash, in kind, as well as in rights or services.

Limited Liability Company

Members: One or more shareholders. Minimum capital: KM 2,000. Company management: The decision-making body of the company is the General Meeting of Shareholders.

Republic Srpska

Business activities in the Republic Srpska are primarily¹⁴ regulated by the Law on Enterprises (published, Official Gazette of RS 24/1998, amended - 62/2002, 38/2003), which is partly based on EU Company Law Directives. The Law on Enterprises recognizes two main types of companies: business and public (i.e., government business enterprises).

Types of businesses include:

- Joint stock,
- Limited liability companies,
- General partnerships,
- Limited partnerships.

Joint-Stock Company

Shareholders: From one to 50 shareholders for companies incorporated simultaneously and two or more shareholders for companies incorporated successively. The General Meeting of Shareholders takes decisions by a qualified majority vote including on the appointment auditors and liquidators, termination of the company as well as distribution of profit.

Limited Liability Company

Members: From one to 30 shareholders; Company management: The company bodies are the Director, the Management Board, the Supervisory Board (if provided by the articles of association) and the General Meeting of Shareholders.

¹⁴**Further relevant laws include:**

RS Bankruptcy Regulation - Legal framework: Bankruptcy Procedures Law (published, Official Gazette of RS 67/2002) and Liquidation Procedures Law (published, Official Gazette of RS 64/2002)

RS Anti-Trust Regulation - Legal framework: Competition Law (published, Official Gazette BiH 30/2001)

Partnerships

Partners: 2 or more - domestic or foreign natural or legal persons. Each member of the general partnership is jointly and severally liable with its property for the partnership's obligations.

Gap

The statutory framework should be further reviewed and harmonized, albeit gradually, with the relevant portions of the *acquis communautaire*. Accounting and auditing regulation should not be revised in a vacuum but rather in the context of a comprehensive review of the statutory framework pertaining to financial reporting. This requires amending relevant laws and legislation (company, banking and insurance, securities market, etc.) in order to establish a sound statutory and regulatory framework and establish the foundations for institutionalized enforcement of those enhanced requirements. The statutory framework should be further gradually amended, through the adoption of Implementing Laws and Regulations in each Entity, and in the District of Brcko, in order to enact the relevant portions of the *acquis communautaire*.

Illustrated Analysis

Reporting Thresholds for Small and Medium Sized Enterprises

The entity laws take advantage of the exemption allowed under the Fourth EU Company Law Directive in order not to impose an excessive audit burden on small- and medium-enterprises. They no longer impose the same accounting and financial reporting requirements on small and medium enterprises (SMEs) as on Public Interest Entities.

However, the thresholds introduced are not in line with those of the EU nor are they consistent across both Entities. The Commission on Accounting & Auditing is in the process of establishing a sub-committee to address the issue of the application of accounting and auditing standards to SMEs.

The SC proposes to require a simplified financial reporting framework to SMEs, which meets the needs of intended users (e.g., lenders) and the capacity of preparers. In this regard, the SC has had regard to the *acquis communautaire*, the experience of other Member States, and the IASB SME project.

Accounting Standards as Designed and Practiced in Bosnia Herzegovina

Accounting requirements and practices are insufficient for investor decision-making. Financial statements are not reliable for financial reporting purposes. Companies view disclosure as a burden rather than a necessity and have little interest / benefit in publishing extensive information. During the ROSC A&A, the World Bank reviewed financial statements of a sample of companies identified a number of instances where the financial statements did not comply with IFRS – lack of disclosure notes, absence of cash flow statements and audit reports, any consolidation or segment reporting and non-disclosure of related party transactions.

3.2 The Statutory Framework for Auditing

The auditing profession is regulated under the 2004 accounting and auditing laws, which have been passed through State and Entity parliaments. This is a significant step for BiH in its progression towards an enhanced financial reporting environment. These laws allow for a number of important actions to align the BiH accounting and auditing environment with European Union requirements. The accounting and auditing laws also meet a significant requirement within the World Bank's ROSC on Accounting & Auditing in BiH.

The State Framework Law creates an entity wide platform for statutory audits. Audits performed and audit reports issued by an auditor licensed in any of the two Entities and the Brcko District will be recognized in all Bosnia and Herzegovina without any additional requirements.

The accounting and auditing laws specifically outlines the auditing standards to be:

- International Standards on Auditing (ISA) issued by the International Federation of Accountants (IFAC) and its independent boards.

The statutory audit is obliged to be performed in accordance with new and amended International Standards of Auditing (ISA) issued by the International Auditing and Assurance Standards Board (IAASB). The last publication of ISA (2004 version) was undertaken in 2005.

The Entity implementing laws impose statutory audit requirements on Public Interest Entities, which should be audited in accordance with auditing standards adopted in the Accounting and Auditing Laws.

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Establishing Oversight of the Audit Profession

The RS and FBiH Implementing Laws set forth a system of public oversight for which the Ministry of Finance is responsible; thus, it acts as a proxy of the public interest. However, such oversight falls short of good practices in EU Member States, as no one stakeholder can claim to adequately represent the interests of the public at large. A proper proxy for the public interest should draw upon a wider constituency, including not only the State & Entity Ministries of Finance, but also the Securities and Exchange Commissions, the Central Bank & Banking Agencies, academia, etc. Although there is no one blueprint as to how to set up an effective public oversight mechanism, BiH should take an approach to public oversight that is aligned with the principles set forth in the Eighth Company Law Directive and draw upon the evolving experience of EU Member States.

Statutory auditors' appointment and termination

The accounting and auditing laws do not cover legal mechanisms pertaining to statutory auditors' appointment and termination. In this respect they are still deficient. There is a need to avoid the situation where the reasons for dismissal and resignation do not have to be disclosed to the responsible oversight authorities. Internationally, it is increasingly common for external auditors to be recommended by an independent audit committee of the board or an equivalent body and to be appointed either by that committee/body or by shareholders directly. The requirement that the board of directors appoint the statutory auditor does not recognize that the auditors owe a duty of due professional care to the business enterprise rather than to a group of executive directors with which they may interact for the purpose of their work.

3.3 The Institutional Framework for Accounting & Auditing

The Independent Commission on Accounting & Auditing

The State Framework Law established a Commission (The Independent Commission on Accounting & Auditing) to monitor the implementation of accounting and auditing standards by the professional bodies. The State Framework Law states that the Commission is responsible for translating and disseminating IASB and IFAC standards and interpretations; establishing qualification requirements; and administering professional examinations, among other activities.

The Commissions functions and jurisdiction are clearly set out in Article 3 of the State Framework Law. The role of the Commission has been clearly established in the BiH Law on Accounting and Auditing 2004. The Commission has been successfully established and has undertaken considerable work to date. A summary of the Commission's activities to date includes for:

- The accounting standards as identified above have been translated into Serbian and the quality assurance of the translation into Bosnian/Croatian is complete (December 2005),
- The auditing standards as identified above including IFACs, Statements of Membership Obligation (SMO) and Education Standards have been translated,
- A uniform program for the qualification, training, testing, certification and licensing for the Accountancy Profession, in full compliance with IFAC standards and guidance, has been established, throughout BiH, and,
- A uniform testing program for the accountancy profession has been established and implementation is underway in all of the territory of BiH.

The Association of Accountants and Auditors in the Republika Srpska (AAARS)

The Association of Accountants and Auditors is the professional accounting and auditing association in the Republika Srpska. Since the implementation of the Dayton Peace Agreement the AAARS has taken significant steps towards meeting IFAC's membership obligations.

The AAARS has implemented a syllabus for the professional education program based upon the ACCA-UK syllabus, as amended to incorporate additional material contained in the UNCTAD model curriculum. The professional education program is being reviewed in 2005 following publication and acceptance of the IFAC International Education Standards. In November 2004 the AAARS became an Associate Member of IFAC, and is working towards the objective of achieving full membership in 2006. It is also a member of SEEPAD. The membership of the AAARS includes 56 certified auditors and 1256 certified accountants according to the association's IFAC membership statement.

The Union of Accounting & Auditing in FBiH (SRRFBiH)

In 2005 the Union of Accounting & Auditing in FBiH held a general assembly at which a new constitution was approved formally recognizing the alignment of 3 separate accounting and auditing associations in existence for the previous decades in FBiH. As of 2006 the total number of registered certified auditors was 41 along with 4000 certified accountants.

Gap

Development of the Oversight of the Audit Profession

The development of an effective system of public oversight that is aligned with the *acquis communautaire* is a key requirement of the audit profession in BiH.

BiH should implement a system of public oversight that is aligned with the proposal for a new Eighth EU Company Law Directive, now adopted by the European Council and Parliament. This system should be headed by an independent body, which is independent of the industry that it regulates, and free from undue political pressure. This independent body should have ultimate responsibility for oversight of the approval and registration of statutory auditors and audit firms, adoption of standards on ethics, internal quality control of audit firms and auditing, and continuing education.

This body should supervise the quality assurance system organized by the professional organizations but must have the right, where necessary, to conduct its own investigations on statutory auditors and audit firms.

Registration of statutory auditors & audit companies

Bosnia & Herzegovina does not currently hold a significant register of statutory auditors and audit firms. It is difficult to determine rapidly whether a statutory auditor or an audit firm has been approved, where it is officially located and how (in the case of firms) they are organized.

Quality Assurance for the Statutory Audit

The professional bodies should enforce the Continuing Professional Education (CPE) requirements and implement an effective system for monitoring CPE attendance. Furthermore, the professional bodies should implement a system of quality assurance to ensure that auditors are subjected to strong disciplinary sanctions if they do not comply with CPE requirements, in order to preclude unqualified auditors from retaining their authorization to practice under the new system

3.4 The Statutory Framework Bank Financial Reporting

In the Federation of Bosnia Herzegovina the Law on Amendments to the Law on Banks (FBiH Official Gazette 41/02), Law on the Banking Agency of the Federation of Bosnia Herzegovina (FBiH Official Gazette 9/96, 27/98, 20/00 & 45/00) and the Law on Banks (FBiH Official Gazette, 39/98, 32/00 AND 48/01) form the primary legislative framework.

The Law on Banks, Law on Banking Agency of Republika Srpska ("Official Gazette of Republika Srpska" number 10/98) and the Office of Representative (OHR) "Decision on Modifications and Amendments to the Law on Banking Agency of Republika Srpska" form the statutory framework for the banking sector in the Republika Srpska

Gap

The statutory framework for the banking sector should be fully aligned with the requirements of the Capital Requirements Directive, the Banking Accounts Directive and the new Eighth EU Company Law Directive to achieve better alignment between the statutory audit and the banking supervision functions. As the requirements of Basel II are being integrated in the Capital Adequacy Directive (CAD 3), it is essential for the banking sector in Bosnia Herzegovina to focus on embracing the changes within Basel II if they are to comply with the *acquis communautaire*.

Illustrated Analysis

Gaps in the legislative framework

In both Entities the banking laws do not set out specific filing or publication requirements for general-purpose financial statements. However the banking laws include additional legal requirements concerning statutory audits of banks. They provide that the appointment of a bank statutory auditor is subject to prior approval by the banking regulator. The banking regulator assesses the auditor's acceptability based on experience and independence but lacks a written and well-known process for such assessment (e.g., the reasons for barring an auditor from auditing a bank are not disclosed), and the auditor has no right of appeal.

3.5 The Institutional Framework for Bank Financial Reporting

Banking supervision is currently carried out by entity agencies, with the CBBH having a coordinating role. There is good cooperation among the three institutions and this was recently formalized by the signing of a memorandum of understanding.

The Central Bank of Bosnia and Herzegovina (CBBH), created in 1997, defines and controls the implementation of monetary policy of Bosnia and Herzegovina, maintains appropriate payment and settlement systems and co-ordinates the activities of the two banking supervisory agencies.

The agency in charge of supervising and regulating the banking sector in the Federation of Bosnia Herzegovina is the Federation Banking Agency (FBA), which was established in 1996.

The banking sector in Republika Srpska is overseen by the Banking Agency of Republika Srpska (ABRS).

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The banking sector is well developed and competitive due to the presence of major foreign banks competing for market share. More than 84 per cent of the sector has been privatized, and around 70 per cent of banking assets are now foreign-owned (total banking assets exceed €4.4 billion). Nevertheless, banking intermediation remains relatively low due to the slow privatization process, low level of foreign investment, and the still untested enforcement of the securities legislation that was recently adopted. In addition, further strengthening of the regulatory and supervisory capacities and reconciliation with EU directives and Basle II accords is required.

The Banking Agencies should enhance their financial reporting, monitoring, and enforcement arrangements. Enforcement comprises several factors, including:

- Clear accounting standards,
- Timely interpretations and implementation guidance,
- Statutory audit,
- Monitoring by supervisors,
- Effective sanctions.

Each of these must work efficiently: the system will be as strong as its weakest part in delivering strong investor and creditor protection. The Banking Agencies have a critical role in ensuring that banks, listed companies, insurance companies, and other public interest entities comply with accurate and consistent application of accounting standards in the financial and securities markets.

Illustrated Analysis

The relationship between bank auditors and supervisors in Bosnia Herzegovina needs to be strengthened to their mutual advantage. There is a need to take account of the Basel Committee's Core Principles for Effective Banking Supervision, the Joint Forum under the aegis of the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) in dealing with issues common to the banking, securities and insurance sectors, including the regulation of financial conglomerates. There is a need to reflect on the IAASB and BCBS guidance on the relationship between auditors and the supervisors of banks. Specifically the following issues should be addressed:

- The primary responsibilities of the board of directors and management;
- The essential features of the role of statutory auditors;
- The essential features of the role of supervisors;
- The relationship between bank supervisors and the statutory auditors; and
- Additional ways in which the auditing profession can contribute to the supervisory process.

3.6 The Statutory & Institutional Framework for Listed entities

The securities markets legal framework in BiH is mostly regulated at Entity level.

In FBiH, the basic legal framework for the establishment, functioning and the development of the capital market is comprised of the Law on Securities, the Law on the Securities Registrar, the Law on the Securities Commission, the Law on Fund Management Companies and Investment Funds, and the Law on Business Companies. Most of the laws were enacted in 1998 and amended in 1999. The FBiH Securities Commission was established at the beginning of 1999 as the independent securities markets regulator in the FBiH.

In RS, the capital markets legal framework is comprised of the Law on Securities (1998 and amended in 2001), the Law on Privatization Investment Funds and Privatization Fund Management Companies (1998), the Law on the Central Registry of Securities (1998) and the Law on Enterprises (1998 and amended in 2003). The RS Securities Commission was established in 2000 on the basis of the Law on Securities as the independent securities markets regulator in the RS. Statutory audit is required for all listed companies financial statements. Shareholders appoint the statutory auditors of listed entities, auditors who

perform audits of listed entities are not appointed for a specified period and rotation of the auditor or audit firm for audits of listed entities is not required

There are two stock exchanges in BiH, one in Banja Luka (RS), and the other in Sarajevo (FBiH).

The Sarajevo Stock Exchange has 485 listed companies and 11 privatization investment funds with a market capitalization of approximately US\$ 1.2 billion.

The Banja Luka Stock Exchange has only three listed companies and 13 privatization investment funds plus 642 on the free market list, with a market capitalization of approximately US\$ 760 million. Trading is primarily related to privatization vouchers.

Gap

The existing laws relating to securities impose specific accounting requirements on listed companies and additional filing requirements on listed companies (e.g., publication on the Securities Commission website etc), but these are not enforced. In practice, issuers do not file their audited financial statements with the relevant Securities & Exchange Commissions.

Based on the discussions with the Securities Commissions the main problem with enforcement is the lack of capacity to undertake the function. The Securities Commissions should enhance their financial reporting, monitoring, and enforcement arrangements.

Additionally in 2004, the **European Bank for Reconstruction and Development (EBRD)** performed an assessment of the extensiveness of securities markets legislation benchmarked against the IOSCO principles¹⁵. The entities scored “medium compliance”, being better only than Serbia and Montenegro and Albania among the countries in South East Europe.

3.7 The Statutory & Institutional Framework for the Insurance Entities

The insurance industry is still developing in BiH. The 10 largest insurance companies in Bosnia hold 70% market share and most policies are written for auto and third party liability (USAID, 2004).

¹⁵ For more information please refer to <http://www.ebrd.com/country/sector/law/articles/cgsmetc.pdf>

BiH Parliamentary Assembly adopted the Law on Insurance Agency of BiH («Official Gazette of BiH, No.12/04). For the purpose of harmonization and adoption of a set of laws that would regulate the insurance sector in the Entities, a working group composed of representatives of both Entities has completed the harmonization of the relevant laws. The RS National Assembly adopted the set of laws and they are in the procedure of publishing. In the FBiH the set of laws is in the parliamentary procedure. It provides for the set up of a State-level insurance agency, responsible for ensuring congruency between entity supervisors, EU convergence, and conciliation of inter-entity supervision disputes.

Currently at the State-level, the Ministry of Finance and Treasury is in charge of the insurance sector. In the FBiH and RS, each Ministry of Finance oversees insurance, but with differences between them. In the Federation the function of the supervision of insurance entities is devolved by law to the Insurance Supervision Authority. In the RS, the Ministry of Finance is in charge of supervision.

The EU has initiated an Insurance Project. Any developments in this sector should be coordinate with proposals contained in this Action Plan.

Gap

The Insurance sector suffers from weak governance practices and the supervisory capacity is limited. The insurance market in BiH is poorly regulated. Insurance companies are not required to comply with specific accounting, auditing, and financial reporting requirements with the exception that the RS Insurance Law requires the board of directors of an insurance company to appoint a statutory auditor and that the appointment must be approved by the Ministry of Finance. Consequently, insurance companies have few additional further obligations than do any other enterprises.

3.8 The Statutory & Institutional Framework for Taxation

BiH has three separate tax administrations operating at entity/district level and it's developing a fourth one, operating at state level. Each administration has its own procedures, tax collection schedules and inspection systems.

Gap

General-purpose annual accounts and consolidated accounts are often influenced by taxation rules and regulations. In order to satisfy the requirements of taxation authorities regarding recognition of revenues and expenses, the preparers of general-purpose annual

accounts and consolidated accounts of small and medium-size private companies and public interest entities often deviate from financial reporting standards and follow tax rules.

3.9 The Framework for the Publication and Filing of Financial Statements

Financial statements are not publicly available. In practice, financial statements are very difficult to obtain. This falls short of the requirement of the First EU Company Law Directive. The Entities do not have a unified access portal giving stakeholders access to (audited) financial statements.

3.10 The Framework for Education and Training

The education segment of the USAID Accounting Reform Project in Bosnia and Herzegovina trained both professors and practitioners over the last number of years in reform of accounting education. However, its effectiveness has been hampered by the rigidity within the university system, which is organized along ethnic lines. The need for structural reform within BiH university sector has been clearly identified by the EU and USAID.

Gap

Education and training in Bosnia Herzegovina relating to accounting and auditing has progressed considerable in recent years. However, due to the significant developments internationally, a program of activities is urgently required to ensure that the current requirements converge towards the adoption of IFRS and international good practice.

The process of changing from central planning to a market model requires significant resources on an on-going basis to continue the process of adoption of a new financial reporting system. Practitioners and professors generally are not familiar with the accounting models that exist in the United States, Germany, England and other market economies and need significant and on-going assistance in learning the new system is the absence of previously adopted learning materials. Also due to the complex language requirements in BiH often are no textbooks or other learning materials they can refer to. Thus, there is a need to translate materials from English.